Steady as she goes

Five factors driving merger arbitrage performance in 2019
M&A deal volume has maintained a solid pace through the last several years of the current bull market (Exhibit 1). But as volatility rises and geopolitical uncertainty increases, what can merger arbitrage investors expect?

Merger arbitrage is a longstanding hedge fund strategy and relatively straightforward: it seeks to capture the risk premia associated with announced transactions. In a world of increasing volatility across asset classes, merger arbitrage has drawn increased attention from asset allocators globally in their search for absolute returns with low correlation and beta to broader markets. Performance of the strategy seems to justify their interest, as merger arbitrage has generated the most consistent alpha across all hedge fund strategies for the past 8 years (Exhibit 2). We believe there are both structural and cyclical forces at work that support the attractiveness of the space. In the coming year, we believe the following five market factors will create continued opportunities for merger arbitrage strategies.

We believe there are both structural and cyclical forces at work that support the attractiveness of the space.

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Exhibit 1: The year in review
Global M&A volume 2002—2018 (USD tn)

Exhibit 2: Drivers of strategy flows
Alpha generation (annualized) from 2010—2018

Source: Dealogic, JPMorgan, 2019 Global M&A Outlook, as of 31 December 2018.

Source: Barclays, 2019 Global Hedge Fund Industry Outlook and Trends, as of 1 January 2019.
Capital market volatility

After years of steady equity market appreciation, volatility has become a bigger factor for investors. Volatility can allow acquirers to be opportunistic in pullbacks and come to an agreed price in long-contemplated transactions. At the same time, volatility increases the implied risk of a deal, which increases potential returns. A recent example is Bristol-Myers Squibb Co.’s announced blockbuster deal to acquire rival Celgene Corp. for USD 74 billion—announced on the first business day of 2019, after Celgene’s 15% decline in December 2018. As market volatility continues, we expect to see more such deals throughout the year.

Record levels of private equity and shareholder activism

Private equity firms have amassed considerable war chests over the past few years, with some estimates quoting over USD 1 trillion of “dry powder” waiting to be deployed. At the same time, assets under management by activist-focused hedge funds have doubled since 2007. Shareholder activism can be a compelling deal catalyst and may drive competitive bidder situations. We expect US activist campaign activity to remain at levels similar to those in 2018, while activism outside the US should grow rapidly as activists seek attractive risk-reward opportunities.

Regulation gets more complicated

When asked about their top obstacle to sourcing, financing and closing deals in the next 12 months, many private equity firms cited their greatest concern (32%) as the potential for delays in key business-related legislation. Larger transactions requiring cross-border approvals are particularly sensitive to shifting political sentiment and local regulations and tend to have a higher degree of business and regulatory complexity—consequently offering higher implied risk and higher potential return.

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2 Pension & Investments, Dry powder holdings at $1.8 trillion – Preqin, as of July 6, 2018.
3 Citi, Dealogic, Executive M&A Summary, as of 31 December 2018.
Interest rate concerns

The US Federal Reserve (Fed) signaled in January it may hold off on rate increases for the time being, which has helped stabilize credit markets. However, a survey of 1,000 US corporate and private equity executives conducted by Deloitte in September 2018 pointed to expectations that the benchmark Fed rate will increase over time, and many consider the expectation of higher rates to accelerate deal-making, perhaps in a rush to take advantage of rates today.

Regional market variations

Global deal activity always fluctuates over time. Recently the volume of deals driven by Chinese acquirers dropped as their economy cooled. By contrast, Japanese companies increased their participation in acquisitions. Additionally, shareholder activism outside the US has been increasing as activists seek attractive risk-reward opportunities in Europe and Asia. According to JP Morgan, in 2018, ~46% of non-US campaigns targeted European companies and ~32% of European campaigns had at least one M&A demand. We expect improving economic conditions and business confidence to drive greater deal volume in Europe, where activity between 2009 and 2017 was below long-term averages, and volume has already begun to pick up.

We believe the changing market, economic and political conditions that have grabbed headlines over the last few months will help drive continued M&A in 2019, offering a wide selection of deals at more attractive spreads. In the aforementioned survey given by Deloitte, 76% of executives at US-headquartered corporations and 87% of partners at US private equity firms said they expect the number of deals their organizations will close over the next year to increase. Overall we believe this backdrop sets the stage for a robust opportunity in the merger arbitrage space today.

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