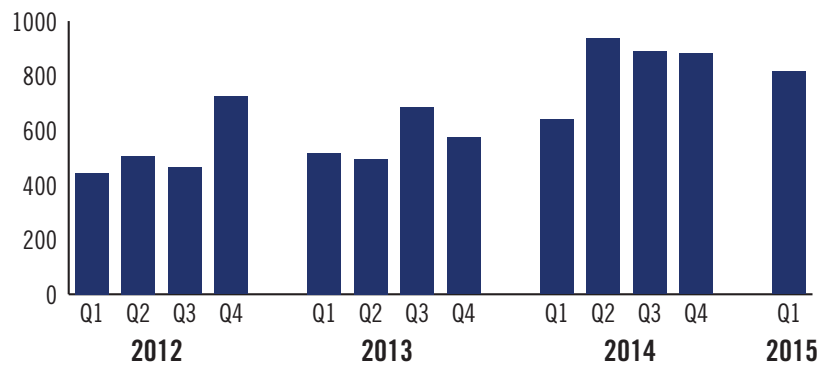




Event-Driven Activity Is Booming, but the Rules of the Game Have Changed

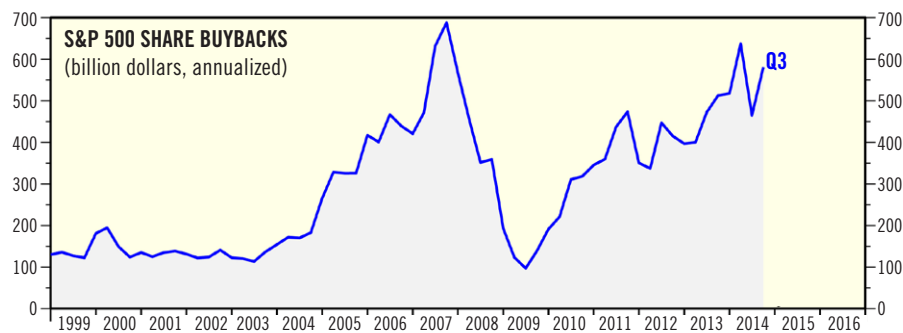
Event-related activity has started 2015 in much the same way it ended 2014—it has been booming. M&A, strategic divestitures, splits, spins, dividend hikes and stock buyback activity have all been occurring at a frenetic pace. For the most part, this activity has been well received by shareholders seeking EPS growth or a return of capital. A glut of cash on corporate balance sheets, historically low interest rates, diminished top-line growth opportunities, and a narrower scope for cost-cutting have created an environment where these trends are likely to continue through the remainder of the year. As shown in Exhibits 1 and 2, both M&A and share repurchase activity has surged as of late.

Exhibit 1. GLOBAL M&A \$ VALUE (2012 – 2014)



Source: Bloomberg, Driehaus Capital Management

Exhibit 2. S&P 500 ANNUALIZED SHARE REPURCHASE VALUE (1999 – 2014)



Source: Yardeni Research

Though we’ve seen multi-year surges in event-related activity before, such as during the late 1990s and mid-2000s, there are several important differences in this cycle. **In this paper, we highlight how changes in the market have necessitated changes by event-driven investors to fully take advantage of the most attractive opportunities that are rising out of this boom in corporate activity.** More specifically, we discuss three themes investors should consider as they pursue these investment opportunities.

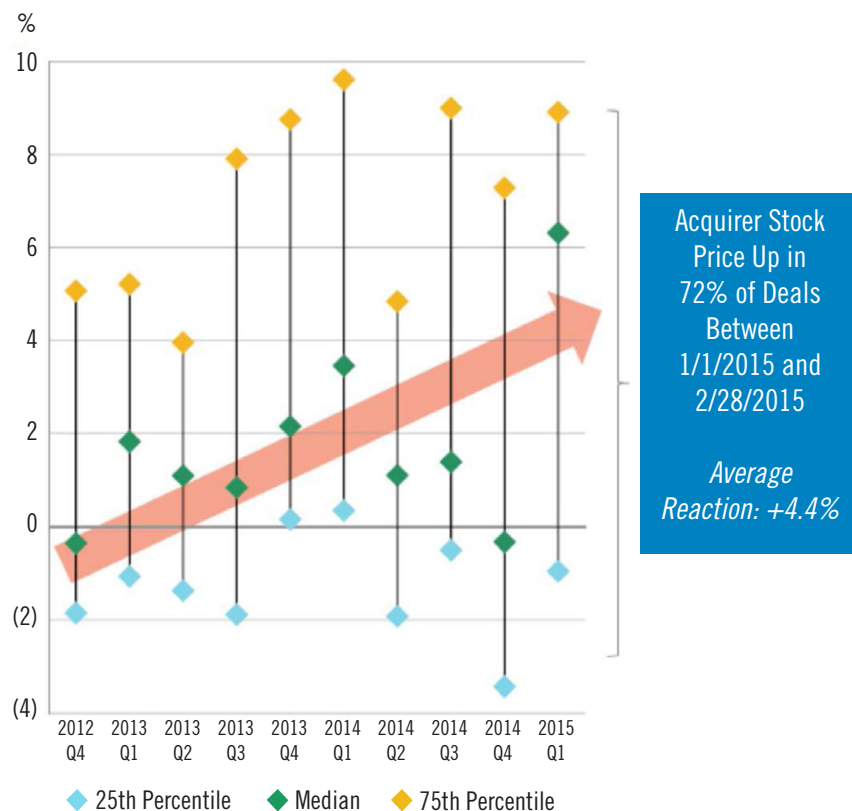
1. The Traditional Risk Arb Approach Now Often Sub-optimizes Potential Returns

One tried and true method for exploiting an increase in deal activity is to harvest a traditional risk arbitrage spread. In this trade, an investor buys the target's stock and simultaneously shorts the acquirer's stock (assuming the deal involves some form of equity exchange). The purpose of the short is twofold. First, the investor hedges their exposure to a decline in the acquirer's stock, which ultimately lowers the value of what they'd receive should the deal be consummated. Second, the investor hedges their risk against a deal break. If there is a deal break, the target's stock often falls sharply as the M&A premium is removed from the equity, while the acquirer's stock falls moderately as potential M&A synergies are removed from its underlying value. Consequently, the short position in the acquirer can offset some of the losses sustained in the target's stock.

However, the traditional risk arbitrage trade structure is losing its effectiveness due to two precedents having changed recently.

First, the acquirers' stock has been rising sharply upon a deal announcement and has continued to rise into deal consummation. As shown in Exhibit 3, this trend has accelerated into first quarter 2015.

Exhibit 3. DISTRIBUTION OF US ACQUIRER STOCK PRICE PERFORMANCE



Source: Thompson Reuters, Capital IQ, Morgan Stanley

Historically, this hasn't been the case. In the past, acquirers' stock often fell when the deal was announced and was under selling pressure or range-bound into the deal close. There are a number of reasons why this has been the case, but to name a few:

- Investors often doubted management teams' lofty goals for M&A synergies;
- Investors questioned if there were better growth opportunities available than the M&A target; and
- Investors feared the M&A transaction may cause management teams to lose focus on their core businesses.

But now, the market's view on these issues has changed—which we will touch on later—and the acquirers' stock has been more likely to rise than fall into deal closure. In these instances, shorting the acquirers' stock will cost you money more often than not in the traditional risk arb approach.

The other reason why the traditional arb setup often now hinders returns is that in many large deals, the acquirers' stock is no longer falling appreciably upon a deal break. Today, a deal break often causes the acquirers' stock to rise as the market assumes that the acquirer will pursue some other accretive opportunity for shareholders, like a buyback, special dividend or another acquisition.

If the short stock position is likely to cost you money into deal close, and it may harm you in a deal break scenario, then why have it? Based on the current market environment, we often find that M&A trades are better structured through outright long positions in the target, or long positions in both the target and acquirers' stocks. A look at Exhibit 4 illustrates this point. The table shows five recent mega-mergers and the net merger arbitrage return versus the return of going long both stocks. As shown, there are now often double-digit differences in returns between the two approaches.

Exhibit 4. Merger Arbitrage Spread vs. Outright Long Target & Acquirer

Target	Acquirer	Date Announced	Date Completed	Merger Arbitrage, Net Return*	Outright Long, Net Return**
Time Warner	Comcast	1/13/2014	TBD	2.9%	12.3%
Covidien	Medtronic	6/15/2014	1/26/2015	6.9%	24.5%
Lorillard	Reynolds	7/15/2014	TBD	11.1%	20.7%
Tim Horton's	Burger King	8/24/2014	12/12/2014	4.7%	14.5%
Auxilium	Endo	10/9/2014	1/29/2015	2.7%	17.3%

* If deal has yet to close, then returns are as of 4/6/2015

** Assumes long both target & acquirer, equally weighted \$ basis

Source: Bloomberg, Driehaus Capital Management

This being the case, one might reasonably ask: How do you hedge against deal break then? The answer is to target the acquirers whose intrinsic value justifies the current share price as a standalone entity. So, to take an outright long position in the acquirer (instead of utilizing it as a hedge), we must feel confident about its prospects in both the scenario in which the deal closes and the alternative scenario of a deal break.

This change in the risk arb framework is not the only theme to be cognizant of in today's changing investment environment. In fact, much of the previous discussion applies to our next theme.

2. If Acquirers Are Being Rewarded, Then Do Something About It!

Traditionally, most event-related funds would have a bucket of stocks that they felt were prime takeover candidates. That's a fruitful, albeit risky endeavor. Identifying takeover targets is extremely difficult and requires a good dose of luck. Companies that are perceived to be prime acquisition targets often trade at lofty multiples with business plans that face significant hurdles in the coming years (hence, the market perception that they would be better off with a strategic partner). Of course, if the company's growth profile slows in the interim, or their management team indicates that they do not wish to partner with another company, then an investor risks a quick contraction in those lofty multiples. Hence, this is a high-risk, high-reward endeavor.

However, if acquirers are rewarded by the market for accretive M&A, strategic partnerships, and share buybacks, then why not pursue those companies as investments? We've decided in many cases to do just that, for several reasons:

- **Serial acquirers are easier to identify than acquisition targets.** Potential acquirers often have a long history of successfully closing deals, a sizable amount of cash on the balance sheet, and a limited amount of growth opportunities in their existing business.
- **These acquirers often trade at a discount to market multiples.** Consequently, the risk of a sharp drawdown is much smaller as compared to potential targets.
- **These companies are now often prodded by shareholders to take action,** so you have an influential party working on your behalf.

To illustrate how much the environment has changed, examine Exhibit 5. We have listed the top 10 M&A transactions in which the acquirer had public equity (as of year-to-date 2015), as well as for 2005.

Exhibit 5. TOP 10 M&A TRANSACTIONS WITH PUBLIC ACQUIRERS (2015 VS. 2005)

2015 YTD				
Announce Date	Target	Acquirer	Anncd Deal Value	Acquirer Anncd Date Price Change
3/9/2015	Macerich	Simon Property Group	20.7	-0.1%
3/4/2015	Pharmacyclics	AbbVie	19.8	-5.7%
1/26/2015	Regency Energy	Energy Transfer	17.2	-6.4%
2/5/2015	Hospira	Pfizer	16.8	2.9%
3/2/2015	Freescale Semi	NXP Semi	15.8	17.3%
3/30/2015	Catamaran	United Health	13.2	2.5%
2/22/2015	Salix Pharma	Valeant Pharma	12.5	14.7%
3/31/2015	Bright House	Charter	10.4	8.0%
1/26/2015	MeadWestvaco	Rock-Tenn	9.7	6.1%
2/4/2015	Office Depot	Staples	5.9	-2.4%
			2015 AVERAGE	3.7%
2005				
Announce Date	Target	Acquirer	Anncd Deal Value	Acquirer Anncd Date Price Change
1/28/2005	Gillette	Proctor & Gamble	57.3	-2.1%
12/12/2005	Burlington Resources	ConocoPhillips	36.1	-5.0%
6/30/2005	MBNA	Bank of America	35.4	-2.8%
12/5/2005	Guidant	Boston Scientific	25.2	-3.6%
4/4/2005	Unocal	Chevron	20	-3.9%
2/28/2005	May Dept	Macy's	16.6	-0.6%
5/9/2005	Cinergy	Duke Energy	13.7	-1.9%
10/31/2005	Place Dome	Barrick Gold	10.2	-7.2%
10/3/2005	Dex Media	RH Donnelley	9.7	-2.4%
4/25/2005	Premcor	Valero	7.8	1.1%
			2005 AVERAGE	-2.8%

Source: Bloomberg, Driehaus Capital Management,

This year, acquirers' stock has appreciated an average of 3.7% on the day of the deal announcement versus just a 1% year-to-date gain for the S&P 500 Index. Ten years ago however, only one acquirer's stock in the largest 10 transactions reacted positively upon deal announcement, despite the S&P 500 finishing up 5% that year.

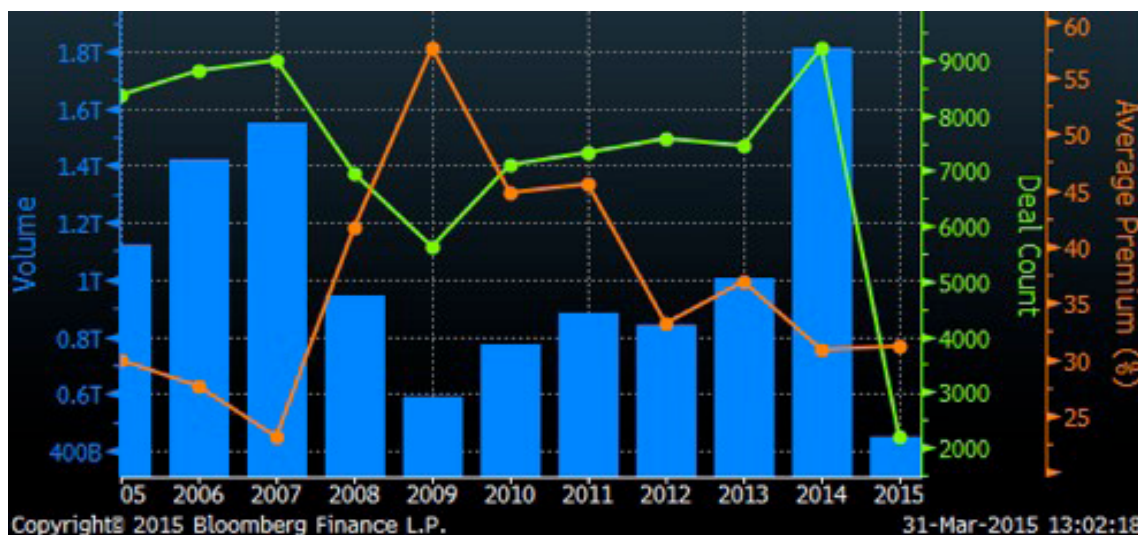
Targeting attractively priced acquirers is a theme that should work for some time to come. We believe investors should seek companies trading at attractive valuations with much to gain from a potential business combination. We see plenty of these opportunities now, particularly in the telecommunications and health care sectors, which brings us to our last major theme to play in 2015.

3. Equity Isn't the Only Game in Town

What's been so exceptional about this period in deal-making history is the dollar value, rather than the absolute number of deals. In Exhibit 6, we've charted the deal count, average premium paid, and total value (in USD trillions) of global M&A activity on a quarterly basis over the past 10 years. While total dollar value of M&A is close to all-time highs, the deal count and premium paid have been about average. This means that the deals that are getting done are fairly large.

Larger deals involve larger companies that often have more complex capital structures. We've found this to be an attractive feature of this M&A cycle, as the number of investable securities within any deal is large by historical standards. Several times we have expressed our investment opinion through an instrument other than straight common stock. We've utilized options and bonds to enhance our total return potential, and/or hedge our downside exposure. In many cases, it appears that not all segments of the capital structure are priced to reflect the same probability of deal closure or potential synergies. We speculate that these inefficiencies exist due to divergent incentive structures among a wide-ranging base of security holders. As long as this deal cycle continues, we believe that large cap companies will continue to participate in event-related activity, leaving us plenty of choices along their capital structure to most effectively structure our trade.

Exhibit 6. GLOBAL M&A ACTIVITY (PAST 10 YEARS)



Source: Bloomberg

One example that illustrates potential inefficiencies resides in the pending Time Warner (TWC)–Comcast transaction. At the beginning of the year we observed that Time Warner’s bonds were implying the company’s deal with Comcast was roughly 85% likely to close. More specifically, post-deal announcement, the TWC 30-year bond traded only 30 basis points wider than Comcast’s. If the deal were to fall apart, we believe that it’s highly likely the more levered Charter Communications (CHTR) will step in and pursue TWC. In such a scenario, we envision the TWC 30-year bond trading to at least 180 basis points wide of Comcast, meaning that immediate post-announcement bond pricing implied about an 85% probability of deal close. Meanwhile, the implied probability of deal closure based on the equity-arb spread has been fairly consistent at roughly 55%.

In light of this capital structure dislocation, we initiated an equity arb spread trade and simultaneously shorted the TWC 30-year bond spread. In this setup, we believe there are many ways to earn a moderate return, and very few ways in which to lose more than a negligible amount of money.

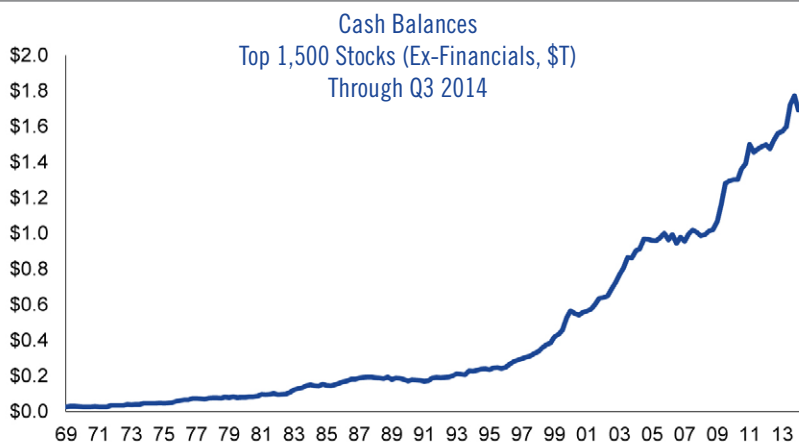
Looking forward, we believe that identifying these opportunities and having expertise with investing across companies’ capital structures will be a profitable source of opportunity for event-driven investors.

CONCLUSION

There are many reasons for the recent changes in the event-driven opportunity set. A few key ones are:

- **Low interest rates.** Let’s say that a given M&A transaction may yield \$100 million in annual synergies. As the market attempts to value this over the next 10 years (or into infinity for that matter), a low interest rate—which directly translates into a lower discount rate on the investment—increases the value of those synergies. For example, \$100 million in annual synergies discounted at 10% into perpetuity yields \$1 billion in present value, while the same \$100 million in synergies discounted at 5% yields \$2 billion. We are not arguing that discount rates have or should be cut in half compared to several years ago, but they should be lower...much lower.
- **Management’s incentives.** So if you’re a CEO and you know that the market is likely to cheer your stock upon deal announcement—compared to years ago, when it was only a question of how much your stock would go down—wouldn’t you behave differently? In the old days, you might over-promise on the synergies front, so your stock wouldn’t get whacked too hard upon deal announcement. Further, you’d likely need sizable synergies to convince your board, shareholders and executive team that the transaction was worth pursuing. Today though, CEOs are under-promising on deal day and saving the over-delivering for the subsequent earnings announcements. That translates into downplaying the synergies so that the transaction receives regulatory approval, leaving room for continued equity appreciation.
- **Rising cash levels.** It’s no big secret that US corporates have stockpiled cash for years. With risk-free rates at record lows globally, corporates have ample firepower and a low opportunity cost (read money market yields of zero and limited organic revenue growth opportunities) in deploying this capital to strategic actions (Exhibit 7).

Exhibit 7. CASH ON CORPORATE BALANCE SHEETS



Source: ClariFi, Thomson Reuters, Morgan Stanley Research

• **Increased shareholder activism.** Again, several years ago the biggest and best US corporates were largely left alone by their shareholder bases. Today, no one is safe. Shareholders at Apple and GM have prodded management to get busy deploying capital or face years of annoyance, and possibly a pink slip. Poor balance sheet utilization has been one of the primary rallying cries of the activist investor community in recent years, and since 2010 the number of activist funds has grown nearly threefold, from 76 in 2010 to more than 200 by year-end 2014. Consequently, inaction is no longer a commonly accepted business practice.

For all of these reasons and more, we believe that we're likely to stay in a heated environment for event-driven activity for some time to come. To best take advantage of these opportunities, we believe investors should:

- 1) Evaluate when/if the traditional risk arbitrage structure is appropriate, and when outright long positions offer a better risk/reward opportunity;
- 2) Target well-positioned acquirers that are likely to continue to be rewarded by the market for smart capital allocation decisions; and
- 3) Utilize the entire capital structure to express an investment idea, rather than solely relying on common stock for exposure.

Emphasizing these concepts and looking out for new ones that may evolve, we'll seek to benefit from an active event-driven environment marked by accretive M&A and accelerating cash returns in 2015.

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NOTES

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