EVENT-DRIVEN
MARKET REVIEW AND OUTLOOK

WESTCHESTER CAPITAL MANAGEMENT
A VIRTUS INVESTMENT PARTNER

"To paraphrase Mark Twain if I may, the reports of M&A's demise were greatly exaggerated."
"As we look back on 2022, it is quite amazing to reflect on how much activity there actually was despite the global tensions created by Russia's invasion of Ukraine, the highest inflation in decades, and rapidly rising interest rates."

– Frank Aquila, Senior M&A Partner with Sullivan & Cromwell LLP

MARKET REVIEW

Mergers & acquisitions (M&A) activity declined in the second half of 2022 from the still-lofty levels of the first half. Aggressive interest rate hikes to fight inflation, a punishing market sell-off, and a looming recession exacerbated pro forma uncertainty for combined corporate entities. As we have stated in previous letters, while activity declined, it remained robust, given the need for companies to find growth avenues, even in a weak economic environment. For the full year 2022, global (M&A) activity totaled $3.65 trillion, following 2021's blockbuster year. Even with macroeconomic headwinds, 39 deals worth over $10 billion were announced in 2022.

Although deal flow on a yearly basis decreased, compared to the record high levels of 2021, we remain comfortable that transaction activity will remain well above historic norms. We continue to see asset aggregation by acquirers seeking to grow through acquisition to increase top lines or market share and realize synergies. In the first two weeks of December alone, dealmakers inked nearly $70 billion in mergers and acquisitions. Biotech giant Amgen Inc. announced on Dec. 12 that it would buy Horizon Therapeutics Plc for $28 billion. Thoma Bravo announced a takeover of business-spend management platform Coupa Software Inc. for $8 billion, including debt; internationally, Novozymes A/S said it would acquire fellow enzyme maker Chr. Hansen Holding A/S for about $12 billion in the biggest-ever deal involving two Danish companies, to name a few.

"Despite macroeconomic concerns, the M&A market will always be dynamic, and there will always be a market for quality targets."

– Alex Aber, a Boston Partner for Hogan Lovells, M&A and Corporate Finance

SPREADS

In a year where both equity and fixed-income markets experienced double-digit losses, arbitrage spreads saw increased volatility as uncertainty increased. Spreads will vary along with the market's perception of deal completion risk. Tighter spreads indicate greater certainty of deal consummation, while wider spreads reflect market doubts regarding deal completion.

Fluctuating spread levels contributed to much of the mark-to-market losses in the first half of the year within the broader event-driven space. Gross spreads in definitive transactions began to widen in late April, concurrent with the significant decline in equity markets, reaching peaks on May 18-19 and even higher median peaks in mid-June. After tightening into mid-August with supportive markets, spreads widened again in the second half of the year as equity markets declined significantly and merger transactions became more concentrated in higher multiple and higher premium sectors such as biotech and technology. At year-end, spreads remained elevated, with average and median of 8.5%/1.9%, respectively, substantially higher than Y/E 2021 levels of only 2.7% and 0.9% (albeit in a much lower interest rate environment).

2022 Date	Description	Non-annualized Spreads Average	Median
April 22	Pre-Stress	3.0%	1.3%
June 16	Stress Peak	9.5%	3.6%
August 12	Post-stress Trough	5.5%	1.6%
October 28	4Q Peak	9.0%	2.4%
December 31	Year End	8.5%	1.9%

Note: Mergers with an equity value in excess of $400 million involving publicly traded targets in the U.S. Arbitrage spreads in the table show the uncapped average of average and median non-annualized spreads (net of LIBOR), subject to a floor of 0%. Source: UBS Special Situations.

Historically, similar periods of widening spreads present opportunities for arbitrageurs to increase weightings in existing positions and to add new positions in situations where the risk/reward profile has become more attractive due to market panic and not individual deal developments. In fact, in our 34-year history, Westchester can often be found in the market as a net buyer when others were dumping stocks in response to market dislocations.

YET, HEADWINDS ABOUND

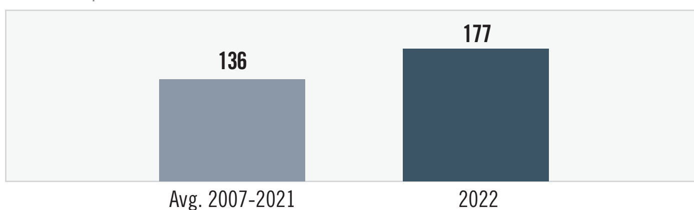
It is worth highlighting that even in the face of market headwinds, acquisition transactions tend to proceed to completion due to the requirements of their legally binding merger agreements. While the challenges may rattle the lay observer, history shows that industry's evolution does not stop indefinitely because of market volatility, macroeconomic hurdles, political uncertainty, and myriad other obstacles to corporate growth. In the short run, however, such challenges can vex buyers and sellers seeking a competitive edge.

Antitrust Scrutiny

Foreign Direct Investment (FDI) scrutiny has become a hot topic, and rising geopolitical tensions have caused governments, intelligence agencies, and regulators to focus more closely on protecting their national interests. Regulatory approvals often incorporate multiple phases, and the more regulatory approvals a deal requires, the longer it will typically take to complete that transaction. As a result, multi-jurisdictional foreign investment reviews are increasingly important to the success of a transaction but also the leading cause of deal delay. In 2022, the average number of days to close jumped by 30%.

AVERAGE NUMBER OF DAYS TO CLOSE

Number of $1B Deals; Average Number of Days Between Announcement and Completion



Source: Citi Banking, Capital Markets & Advisory, Mergers & Acquisitions, Dealogic.

Extended timelines affect expected rates of return; therefore, it is incumbent upon us to factor these expectations into our analysis. In some cases, the market-implied timing of a transaction may differ from our internal forecast, causing the arbitrage spread to be inefficiently priced in either direction. Given our research resources and expertise in evaluating complicated transactions, some of the best opportunities often occur during periods of increased complexity, such as last year.

RECESSIONARY FEARS LOOM

In previous M&A cycles, deal volume initially declined early in economic downturns, often prompted by exogenous events such as the Dot-Com Bubble, Global Financial Crisis, and COVID. However, as companies, private equity (PE) firms, and other investors reassessed portfolios and strategies, their willingness to buy grew, prompted by lower target valuations. With more attractive target valuations, M&A activity typically accelerated, resulting in significant rebounds after recessions.

GLOBAL M&A VOLUME DECREASES DURING RECESSION BUT REBOUNDS AFTER

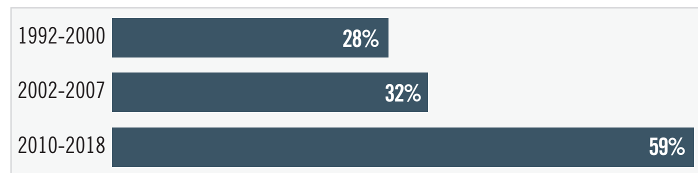
	Volumes	
	Recessionary Periods	Post-Recessionary Periods[1]
Recessions	Peak to Trough[2]	Trough to Recovery[3]
Dotcom	-45.50%	-13.10%
GFC	-57.40	22.50
COVID	-36.90	70.60
Average	-46.60	26.70

Source: Refinitiv, Dealogic, FactSet. Global M&A over $500mm from 1995-2022. Notes: (1) Post-recession defined as 1yr post-recession. (2) Percentage decline calculated from the average of four quarters pre-recession to trough. (3) Percentage increase calculated from recession trough to the average of the four quarters post-recession to trough.

While we cannot predict the future, the differences between then and now are apparent. Funding considerations have substantially shifted toward cash, and the equity markets finance a smaller percentage of deals. All-cash offers continued to be the dominant form of deal consideration in 2022, with its share rising to 65% of all transactions, up from the previous five-year average of 52%, according to Citi.

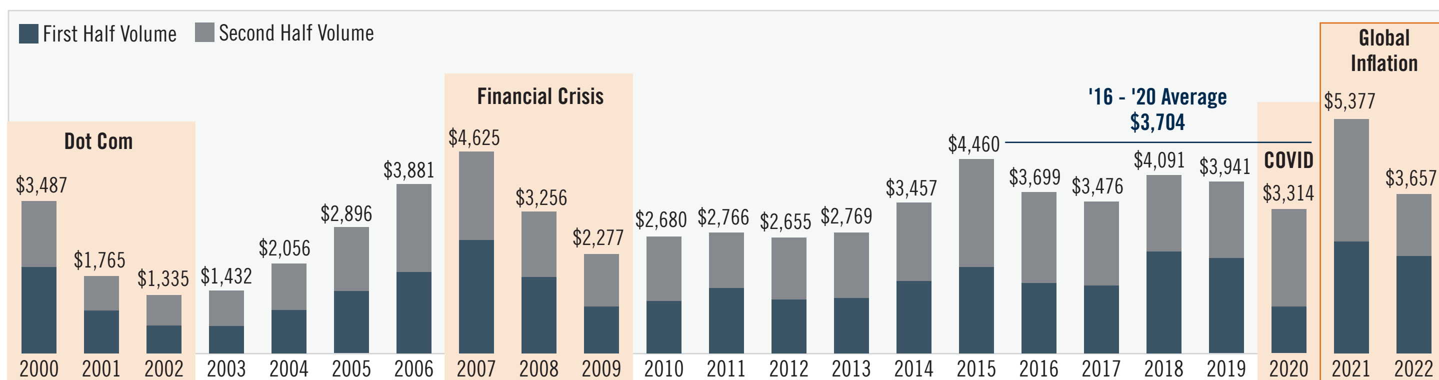
CASH IS KING

The % of total deal value for which cash was a funding source



Source: PwC analysis of Refinitiv data.

GLOBAL ANNOUNCED M&A VOLUME US$B Year-to-Date through December 31, 2022



Source: Citi Banking, Capital Markets & Advisory, Mergers & Acquisitions, Dealogic. (1) M&A activity excludes de-SPAC volume.

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While the Federal Reserve continues to raise interest rates to dampen inflation, downturns can be a good time for deal hunting. As a recent Boston Consulting Group (BCG) report put it, "Savvy buyers and sellers will continue to use M&A to create value even in unfavorable conditions," BCG said.[1]

In other words, transformative M&A typically takes place during all parts of the economic cycle.

NEED TO DEPLOY DRY POWDER INTENSIFIES

Strategic Buyers

Despite potential economic headwinds, M&A activity, as well as prospects, are encouraging. Transaction drivers in recent years – such as digital transformation, supply chain disruption, portfolio optimization, and ESG considerations – will remain influential in 2023.

Moreover, for corporate buyers with a strategic agenda, M&A tends not to be cyclical. With more affordable valuations (the S&P 500® was down 19% and NASDAQ down 33% in 2022), strategic buyers typically take the opportunity to target lower multiple acquisitions. Cash-rich companies will continue to seek to expand or add capabilities, which lately has been in the healthcare and technology sectors. Among S&P 500 constituents, there is $1.7 trillion in cash and short-term investments sitting on balance sheets ready to transact, according to Prequin.

Additionally, the number of distressed sellers is likely to increase. Many companies are over-leveraged and struggling in this inflationary and rising-rate environment. Some are likely to default, given their difficulties and the withdrawal of government relief. Moreover, banks are unlikely to give borrowers more time to fix their problems, inevitably leading to more distressed M&A. An increase in distressed sellers should also create more opportunities for financial sponsors and private equity buyers.

Private Equity

While antitrust hurdles are less of an obstacle for financial sponsors, higher interest rates created headwinds for financially driven M&A in the second half of 2022, which may continue into 2023. Higher rates increase the cost of acquisition financing, often leading some more leveraged acquirers to be outbid by strategic buyers. This is, in large part, why PE activity narrowed in the last half of 2022: banks, after suffering steep losses on certain deals financed earlier in the year, started to pull back on lending for big-ticket transactions, choking off the financing that fueled the pre-and-post-pandemic boom in dealmaking. Despite this factor, financial sponsors had their second-strongest year ever, with over $800 billion in announced volume in North American acquisitions alone, their strongest year since their 2007 peak.[2]

It is estimated that PE funds combined have over $2 trillion in available equity funding to commit to future transactions, so we do not doubt that they will continue to participate in future corporate consolidation. However, structures may change, as we began to see in the latter half of 2022, with more direct lending and "club deals" designed to spread out emerging risk.

Corporate Divestitures

From residential mortgage rates to corporate financing, borrowing costs have had their most significant increase in nearly 40 years. In response, more companies will likely turn to sales, separations, and divestitures of non-core and underperforming assets to drive value and, in some cases, to stay afloat. Strong balance sheets mean that both strategic and financial buyers will be in an excellent position to take advantage of such opportunities. However, the valuation gap between buyers and sellers still needs to tighten further. When stocks are down, companies are more reluctant to issue shares at depressed prices and use the proceeds to fund M&A. Also, the lower stock prices bring down the valuation targets—whether public or private— and potential sellers are reluctant to commit to deals at lower valuations. Using history as a guide, however, quality businesses will always sell, even in tough times, so long as an agreement on valuation can be reached between buyer and seller. This rationalization process has already begun.

Activist Pressures Continue

Additionally, activist campaigns are expected to remain at high levels with an increased focus on operational efficiency, portfolio optimization, and capital allocation. As such, we expect to see an increase in corporate separations and divestitures as the recent spike in the cost of capital incentivizes them to re-evaluate their portfolios. Over the last five years, recapitalizations accounted for over $2 trillion of U.S. volume, with over $600 billion attributable to spin-offs and other public market transactions. Citigroup expects to see the spin-off pipeline increase compared to 2022, with an estimated 25 mega-cap breakups and asset sales scheduled to close in 2023.

[1]Boston Consulting Group, "The 2022 M&A Report," bcg.com, October 20, 2022.
[2]Citi Banking, Capital Markets & Advisory | Mergers & Acquisitions | Dealogic

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Authored by:

The Westchester Capital Management Team

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