# The Deal or No Deal of Event-Driven Investing

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**Anu Rajakumar:** Event driven investing has created alpha generating opportunities for decades by seeking to capitalize on market inefficiencies due to corporate events such as mergers, acquisitions, spinoffs and bankruptcies. Particularly in volatile markets, experienced investors can uncover mispricings to make deals happen, but only if they're sharp enough to find them. My name is Anu Rajakumar and today, I'm joined by two members of Neuberger Berman's Principal Strategies Group in Chicago, Joe Rotter and Jonathan Adolph to share more about what actually goes into the deal making process. Gentlemen, thanks so much for coming to the show.

**Joe Rotter:** Pleasure to be here. Thank you for having us.

**Jonathan Adolph:** Thanks for having us.

**Anu:** So, Joe, let's start with you.

**Joe:** Mm-hmm.

**Anu:** Would you begin by giving us an explanation about what event-driven investing really is?

**Joe:** Sure. Event-driven investing is a relatively broad term. I think it's generally used to describe different ways to-to access unique opportunities in the marketplace, both in equities and in credit. On the broad spectrum of what I'd say is event-driven, you'll have merger arbitrage where investors are looking to invest in the outcome of announced, M&A deals. then you have other equities. We call it catalyst, it can be called special situations where, there's a divergence if you will. There's some type of event path or catalyst that's going to be, the primary explanatory power of that equities, return in a given year as opposed to, you know, multiple expansion, multiple, contraction or simply if that company's just operationally performing better than expectations or not. and I think then as you go from equities, you can also go into opportunities in distress credit, as well. we focus on the equity side of the spectrum. so in merger arbitrage and-and in, like I said, what we call catalyst. Event-driven also, comes in, some different flavors with respect to market directionality, or beta. at Neuberger Berman, the Principal Strategies Group, we, have a market neutral, beta neutral, approach, to extracting alpha. So we-we focus primarily, on merger arbitrage. that can be an extremely attractive opportunity set at times. It's dependent obviously on, deal announcements, deal flow. It's also dependent on, how those, deals are priced, right? How much, premium there is in them. And so, we're not constantly wed to being in that space, but when it's extremely attractive, it can be a great place to deploy capital. And on the catalyst side, you know, the team is really trying to identify stocks in any given sector, where it's not primarily earnings that's going to drive that stock, right? There could be a business shift/sale of a division. there could be a material litigation, regulatory change, not really, selling more widgets in the quarter, so to speak. and so the focus is if you're able to, handicap both the probability of-of those events and understanding the process around those events, and wedding that with fundamental valuation, you're able to extract alpha and capitalize on those opportunities in the marketplace.

**Anu:** Right. Excellent. That's very helpful. Good background for the space. Jonathan, I'll turn to you next and maybe dig in a little bit deeper on some of the comments that Joe just made. He mentioned you have a market neutral approach and that you take a look at the opportunity set and generally, focus on two areas, the catalyst and the merger arbitrage opportunities. Walk us through how your team assesses those and how does the current investment environment affect the sourcing of those opportunities?

**Jonathan:** Of course, happy to. On the merger arb side, one of the beauties of the strategy is that if company, you know, A decides to acquire company B, to the extent that the terms of that contract and that purchase agreement are satisfied, you can capture the spread that exists in the market, pre-transaction. So to give an example, if an acquisition was made for a stock, at a $100 value, it won't trade. You won't have $100, that day will trade at a discount to that. And that spread is what we're trying to capture. And that spread is set by a number of factors: a time to closure, but also the idiosyncratic complexities of that transaction. Four areas of risk that we tend to look at, one is very company specific, meaning, is the company going to financially satisfy the terms of transaction? As well as to the extent that that transaction breaks, is the company in a declining state? Or is it actually going to stay at that pre-valuation level? That's company specific risk. There are issues in terms of evaluating and assessing the shareholder vote. You know, are shareholders going to approve it? Is it going to be an overbid situation? A great source of risk in merger arb transactions tends to be in the regulatory camp. Antitrust obviously is a very big issue. And that obviously affects the probability of deal closure and takes a lot of research in terms of understanding the process and the cases that the government and the companies may have. And lastly, there's a sort of I'd say a catchall of a spoke risk, which could be anything from a tax ruling or a financing contingency. But as we assess all those risks, we're trying to determine our own probabilities of the closure of the event, what the transaction potentially could be if there was an overbid or frankly, if the deal breaks, how much could we lose? And so, it becomes very definable in terms of, in a very process-based, approach to understanding, how to source that alpha. I'll turn to Joe may be to talk about sort of the catalyst opportunity set now. Just he has a little bit of a different process.

**Joe:** Sure. Thanks, Jonathan. Yeah, I think as far as hitting on the catalyst side, rewinding a little bit, going back in time, right? We've obviously post 2008 and the global financial crisis, while there had been speed bumps and some tough times, we've had low rates and we've really had kind of a market up into the right and a significant amount also of multiple expansion. During those times, there are companies that will go through various different types of events or catalysts to extract or unlock value in their equity. However, it's really in times like this a backdrop of more global uncertainty. Obviously, a lot of discussion around rates, around inflation, and geopolitical backdrop. When you don't have the tailwind of kind of this multiple expansion in a rising market, you have a larger percentage of companies that will look internally to see what levers they may pull to drive value for their various constituencies. They are going to have employees that are incentivized with stock. They have shareholders. And so they need to really, go a little bit, deeper and think long and hard. And they're also a lot more receptive to shareholders, whether they be activists, constructivist, or just concerned and thoughtful shareholders, providing feedback. I think you've seen boardrooms and management teams [be] a lot more receptive. And so I would say our hunting ground, if you will, in a backdrop like we have today, is a lot larger. It does come as well though with risks. I think we can discuss that a little bit, but I think there'll be a higher percentage of those types of companies that sell divisions, or acquire other companies, or split themselves, so that does bode well. And on the current environment, on the merger arb opportunity set, we are seeing extremely attractive risk rewards. And I think that's also on the backdrop of, you know, there have been, as Jonathan said, regulatory is a key risk. And we're coming off the heels of several deals that have hit impediments: Rogers DuPont, Standard General, First Horizon, TD, all have had difficulties with their pending regulatory approvals. And I think that has caused the asset class to re-rate in a very attractive opportunity set for those who are selective and really can put an investment process around a true handicapping of the probability of success around those regulatory risks. We will need some new deal flow to replenish that attractive risk-reward of opportunity set. And we have seen some green shoots in M&A activity. We've seen a couple hostile deals, announced. That's good. That means you see boardrooms wanting to acquire. As I mentioned before in this backdrop, you will see companies try to unlock value in other ways. I think you will see more deal flow.

**Anu:** Now, Joe, you've mentioned that the current investment environment is fairly fertile ground for deal sourcing. I'm just curious, are you seeing opportunities in any specific sectors, or industries, or are the opportunities more broad-based?

**Joe:** Sure. I think that right now we're seeing a pretty broad-based, just because of, obviously there's no sector that I would say that has an easy tailwind behind their backs. And so, there can be times where we've found better opportunities in given sectors, right? You might have a regulatory change, right? Or a reimbursement dynamic in healthcare where it simply does make a certain sector more attractive or a higher percentage of companies looking to do things. I think right now we're actually seeing it probably as about as broad-based, as we've seen over the past call it, 5 to 10 years.

**Anu:** Sure. Now, you both have laid out some very important risks, alongside the value proposition, but you know, you've mentioned company-specific risks. Are shareholders going to approve tax financing? Regulatory is a big one. How do you as investors seek to mitigate some of those really key risks when it comes to investing in this space?

**Jonathan:** I think in the merger arb space, there's sort of four areas that you can have a differentiated view on. Firstly, you can have a different view on timing that may not be as important in most, but you can play things that way in terms of how long a transaction will take because you will get compensated for the timeframe in terms of which you hold that spread to realize that risk, or realize the return. You can have a different view on the upside: meaning that, is this going to be a competitive situation? You can have a different view on the downside, meaning how much can you lose, and how much you can lose if the deal breaks. And lastly, you can have a deal different view on the market and probability. And so really, it becomes a very process based to assessing those. The one thing, especially in merger arb that's important to note in this environment, is generally deals in normal times price above the risk-free rate, meaning that it'll compensate you for where interest rates are, over the timeframe and they'll set above that. So it just gets back to, sort of, the deal flow concepts that Joe was highlighting.

**Joe:** Yeah, I think one other thing that's important to highlight that really can come to light in a venture of investing is the concept of correlation. While these deals will generally close, for idiosyncratic reasons, they are able to successfully navigate and satisfy the conditions of the merger agreement. You can have correlation amongst event-driven investments, not just event-driven investors, obviously, or risk arbitrageurs, you know, in that they own them. By way of background, I used to be an M&A attorney. Several times in my career, you see that M&A waves are really driven by a fad or a trend, right? That's been the case for decades. But if that fad or trend ends up rearing its head as a risk, you know, then you can have, correlation, amongst spreads. Recently we've seen the FTC take some very novel, legal action on antitrust, unsuccessfully. But had that been successful, even if you're not participating in that transaction by owning several other deals with a similar antitrust risk, you have exposure to that event, right? That is a correlated event. And we've seen that at some very punctuated points in time, especially in the merger upside. In 2014, you had tax inversions where US-based companies were doing deals by way of a reverse subsidiary merger to change their tax address from US to a global taxpayer to get those tax savings. In '07, obviously, we saw highly leveraged transactions, pick toggle debt, cheap cost of capital. And recently, we've seen the correlation amongst spreads on the regulatory front: Chinese regulatory approvals with some tensions with the Trump administration, had priced with a significant amount of premium, especially after the NXPI deal broke. And so you need to be able to calibrate those, carefully mind those and understand exactly what you are holding, even derivatively, because of those correlated risks that can at times rear their heads and have contagion in the event-driven investing space.

**Jonathan:** And then to add that to sort of the same concept of understanding where risks are on the catalyst side of the book, you know, it's really understanding and trying to isolate what you're playing for, meaning that you can have environments where you can identify something that you think is going to happen at a company. They're going to spin off a division two or recapitalize their balance sheet, and you're waiting for that announcement. But there are oftentimes you don't know when that announcement's going to be made. And that announcement can be made on a down day in the market or a volatile period of time. and if you're leading along in that structure, you may actually not see much alpha creation except for outperformance, losing less money. If you think about it in a relative value construct in terms of relative to a risk-managed hedging construct, even if markets are volatile or down, you can extract that relative difference between the catalyst you're playing for and the hedging basket that you've set up against that trade. And so trade construction also becomes very important.

**Anu:** Yeah, absolutely. It sounds like structuring execution; the implementation is just as important as the deal sourcing itself in these kind of strategies.

**Joe:** Absolutely.

**Anu:** And just to pick up on something, Joe, that you said earlier on, you know, based on your experiences as an attorney in M&A, you mentioned a lot of this kind of activity is based on fads or trends. Can you comment on any fad or trend that you saw, but decided these deals do not look like something that that we want to get involved in at this point?

**Joe:** So even when you had difficulties with some of these fads, it's never been the case that every single deal exposed to that fad or risk broke. And so I think that there have been times we've required a much higher return, a much better risk-reward to underwrite that risk, right? I think that for us, everything comes down to risk and reward. Event-driven investors see probabilities everywhere, right? If it's one up two down, it's priced in a 67% odds of success. And then really, you know, judgment, as kind of loose of a concept as that is, is unbelievably important, right? How you weigh the pieces of the puzzle, and discipline to your risk and reward. Sometimes we have encountered scenarios where unless you really think the next deal that's up for approval or non-approval is going to work, you really should not be invested in the rest of the analogous space, even if you ultimately think they will close. sometimes it's really important to be patient in the deployment of capital. And I think that dovetails in as well to our approach to merger arb, which is we don't just set up a deal when it's announced and hold that spread until it closes. We understand not only and will trade the entire timeline, right? The average deal takes roughly five months these days if there is re regulatory risk, it obviously can take longer. There's a lot of mini events in that timeline where you're underwriting more risk. And you actually have to have a very robust, conversation and calibration, if you will, of correlation amongst those deals and overlay those timelines. So it's not as simple as "I believe this deal is going to close." We will both go long and reverse spreads. There have been times in the marketplace we've reversed a spread, based on its risk reward into its next event, on a deal that we've had very high conviction would ultimately close. So you really need to understand exactly what you're holding, when you're holding it, and what exposures you have in merger arb.

**Jonathan:** And to add to that, you know, because it's a defined opportunity set of announced deals, not owning something in a small opportunity set is as much of an investment decision as owning it. Meaning that, even though there's a high probability of deal closure, um, and people will sometimes set up those spreads just so more, almost systematically, not owning it, can be, as much of a benefit from eliminating that left tail that sometimes associated these transactions.

**Anu:** Absolutely, no, those are great points. As we look to wrap up here, you know, we've covered a lot of really important ground today. Would love it if you could just share maybe three or four key takeaways that you want our listeners to walk away with.

**Jonathan:** I think hopefully the point came across that, event-driven and investing, can offer an uncorrelated source of alpha, where outcomes of events, whether they be catalyst events or merger arb transactions, can manifest themselves, regardless of market direction or levels. And so in this sort of environment, we think that can be an attractive way of generating a differentiated return stream. I think the notion of, “what is hedge fund investing and how to extract alpha?” -- that's very important in this environment. We don't want to be, from our investment, philosophy, beholden to any type of market, state or condition or trend to be able to generate returns and are looking for more consistency, in terms of extracting those types of returns. You know, and lastly, just in terms of, these times that we're in, it gets back to sort of idea generation and where we going to deploy capital, traditional stories where, you know, the company's just going to continue to grow or accelerate or rely on the multiple expansion or tailwind concept, can be challenged in this environment. And in finding companies that are pressed from their stakeholders to find other ways to extract value should be a robust period for investors in event-driven investing.

**Anu:** All right, terrific. Thank you very much for that. Now, I can't let you go without a quick bonus question. The world of Wall Street, and mergers and acquisitions in particular, have been dramatized by Hollywood a number of times over the last several decades. I'm curious if you could share a favorite movie or a TV show that's related to our industry.

**Jonathan:** Well, as I just watched it on a marketing trip, for the first time many years, it's got to be trading places. You know, just in terms of understanding the structure and the trades and you know, how you can work both directions on it, I think, in a fun way as well.

**Anu:** I was going to say, that's a more lighthearted than some of the other big Wall Street movies and everything. So, yeah, I like that one as well. [laughs] Thank you very much for sharing. This has been a great conversation. You know, a strategy like this that's market neutral, that can deliver uncorrelated sources of returns are particularly appealing to many invested at the moment. So appreciate your transparency and walking through how you approach deal flow in the event-driven space. Joe, Jonathan, thank you for joining me today.

**Jonathan:** Great. It's been fun. Thanks so much.

**Joe:** Thank you. Greatly appreciate it.

**Anu**: And to our listeners, if you've liked what you've heard today on *Disruptive Forces,* I encourage you to subscribe to the show via Apple Podcast, Google Podcast, or Spotify. And if you'd like to read more from the Principal Strategies Group, they recently released a paper titled Merger Arbitrage Investing When Deals Fall Through. And that's available on our website, mb.com, where you can also find more information about our firm and offerings.