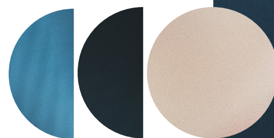
CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Mergers and acquisitions to diversify your portfolio

60 seconds with the fund manager



JUNE 2024

This marketing communication is intended for non-professional investors.

Bertrand Dardenne

Head of Risk Arbitrage

Félix Schlang

Portfolio Manager

Bertrand Dardenne and Félix Schlang, managers of the merger arbitrage strategy[1], explain the benefits of integrating this type of investment into your portfolio.

Can you explain your approach to the merger arbitrage strategy?

Let's start by defining what a «merger arbitrage» strategy is: it essentially consists of investing in companies already involved in M&A transactions, and aims to profit from the differential between the price offered for the buyout and that currently priced in by the market. The investment universe for merger arbitrage therefore comprises all M&A transactions involving listed companies. When a confirmed transaction is announced, the acquirer communicates to the markets its intention to acquire the target company at a price agreed between the parties. The target's share price naturally tends to approach this offer price, although it does not always reach it completely.

In order for the transaction to be completed and for the target's shareholders to obtain the proposed price, various conditions specific to each operation must be met. The manager's role is therefore to understand the risks and timeframes associated with these conditions, and then to determine the appropriate remuneration based on these elements. This remuneration will take the form of the difference, known as the «spread», between the announced transaction price and the target's actual market price. The higher the risk of transaction failure for example lack of regulatory approval, the wider the spread.

By adopting an approach based on a strategic understanding of transactions and their valuations, we select quality transactions and identify targets likely to become the focus of stock market battles or bid improvements, which is a key driver of potential outperformance for our strategy.

What are the advantages of investing in this strategy?

When a company is about to be acquired or merged, its share price is virtually no longer determined by its fundamentals, i.e. its financial performance, but rather by news about the operation in question. As a result, stocks involved in mergers and acquisitions tend to evolve independently of the market as a whole and of each other.

An M&A arbitrage strategy can offer advantages such as low exposure to market trends, given the historically low transaction failure rate (5%) [2], which means controlled volatility and stable returns. This can make this strategy a good portfolio diversifier.

However, it's important to note that this strategy also entails risks, such as the risk that the transaction will fail, resulting in a price correction on the target issuer's stock. It is therefore essential to understand these risks before investing in an M&A arbitrage strategy.

How do you implement your strategy?

We apply our arbitrage strategy by studying each transaction from a corporate and market finance perspective. This analysis, combining fundamental and quantitative approaches, aims to enable us to select

60 SECONDS WITH THE FUND MANAGER

(1) M&A arbitration.
(2) Source : Candriam since 2020.

the transactions most likely to close successfully at the offer price. Our aim is to understand the logic behind each operation and identify the associated risks.

First, we evaluate the offer price of the merger or acquisition using comparative valuation methods in relation to similar companies and past transactions. We then examine the terms of the offer to identify any conditions that could potentially jeopardize the success of the operation. These conditions are classified into six categories:

- approval by the Board of Directors,

- the approval of the target's and the acquirer's shareholders,

- the approval of the competition authorities,

- regulatory approval,

- financing the operation,

- significant adverse events.

This analysis also enables us to estimate the time needed to complete the operation.

Once this analysis phase is complete, we monitor the spread on the market, and if we judge that the risk/return ratio of the transaction is favorable in relation to the available return on our money market cash, we invest.

We then monitor the transaction on a daily basis and adjust our position according to spread fluctuations. Portfolio construction takes into account risk, duration(3) and diversification. To manage the downside risk of a failed trade, we've designed a dynamic tool that evaluates the downside potential (the price at which the stock would fall in the event of failure). In addition, we have set up stop-loss(4) systems to limit the maximum potential loss(5).

We therefore favour an investment approach focused on a solid, low-risk core, which helps us achieve our management objectives. To this, we selectively add transactions with a slightly higher level of risk, such as those likely to feature stock market battles resulting in higher expected returns.

What are the performance drivers of the strategy?

The success of arbitrage strategies depends on two main factors: the volume of transactions and the level of spreads. A large number of announced transactions offers multiple investment opportunities, while a satisfactory average spread in relation to management objectives is crucial to profitability. These items have volume and margin effects on performance, respectively.

The level of spreads can be thought of as three categories of transactions:

- Transactions perceived as low-risk by the market, offering an expected return slightly higher than the risk-free rate.

- Transactions deemed risky by the market, with an expected return substantially above the risk-free rate.

- Transactions where the market anticipates, and prices in, an improvement in the terms of the offer, resulting in a negative expected return if the terms of the offer are met.

To be fully successful in implementing a merger arbitrage strategy, it is crucial to avoid failed deals as much as possible, and to maintain a high level of diversification to mitigate the impact of any failure. Thus, a well-constructed merger arbitrage portfolio will consist mainly comprise of low-risk transactions, ensuring a potential return slightly higher than the risk-free rate. It will also include a cautious selection of risky transactions - for instance , through an understanding of shareholder voting, regulatory approvals - to seek to increase this return, as well as a component of transactions offering the potential to improve the terms of the offer, which is a significant driver of outperformance for a merger arbitrage strategy.

When is the right time to invest in merger arbitrage ?

As far as transaction volumes are concerned, an environment characterized by stable or falling interest rates offers the visibility buyers need to sustain dynamic M&A activity. In particular, financial buyers such as Private Equity funds will also be more active if financing costs are moderate.

As for spread, or expected return, the regulatory environment plays a decisive role. Thus, a liberal policy in terms of competition tends to be favorable. Although the level of interest rates has no net impact on spreads, a fall in interest rates is beneficial for arbitrage managers who have embedded duration(6) in their portfolios. In an environment of normalized interest rates, where valuation levels of traditional asset classes can be considered high, this strategy aims to offer an attractive investment solution.

(3) Duration measures the sensitivity of the price (principal value) of a bond investment to changes in interest rates.
(4) A "stop-loss" can be defined as an advance order to sell an asset when it reaches a certain price level.
(5) Drawdown, or "maximum successive loss", is an indicator of the risk of a portfolio chosen on the basis of a certain strategy. Drawdown measures the steepest decline in the value of a portfolio.
(6) Embedded duration is an indicator of the sensitivity of a financial investment to changes in interest rates.

Announcement date	Payment type	Target name	Acquirer name	Total value in millions of dollars	Deal status	Target country	Acquirer country	Target industry	Announced premium %
18/01/2022	Cash	Activision Blizzard Inc	Microsoft Corp	67883	Completed	U.S.	U.S.	Entertainment Software	46
25/04/2022	Cash	Twitter inc	Private Investor	36760	Completed	U.S.	U.S.	Internet Content-Entmnt	20
15/11/2022	Cash	Somfy SA	Private Investor	1376	Completed	France	U.S.	Electric Products-Misc	33
02/05/2023	Cash	Electricité de France SA	French Republic	2007	Completed	France	France	Electric-Generation	1
14/05/2021	Cash	SUEZ	Veolia Environnment SA	18700	Completed	France	France	Water	0
11/02/2024	Cash	Tod's SpA	Consortium led by LVMH	655	Pending	Italy	France	Footwear&Related Apparel	30
22/01/2024	Cash	Kindred Group PLC	La Française des Jeux SAEM	29230	Pending	Malta	France	Internet Gambling	36
12/12/2022	Cash	Horizon therapeutics Plc	Amgen Inc	26961	Completed	U.S.	U.S.	Medical-Biomedical/Gene	36
05/11/2021	Cash	McAfee Corp	Consortium led by GIC Pte	13301	Completed	U.S.	Singapore	Computer Data Security	20
28/07/2021	Cash	Europcar Mobility Group SA	Volkswagen AG, pon Holdings BV, Attestor Ltd	5125	Completed	France	Germany, Netherlands, UK	Rental Auto/Equipment	44
21/09/2023	Cash	Splunk Inc	Cisco Systems Inc	27951	Completed	U.S.	U.S.	Computer Software	31
19/03/2023	Stock	Credit Suisse Group AG	UBS Group AG	3475	Completed	Switzerland	Switzerland	Diversified Banking Inst	66
02/11/2023	Stock	Six flags Entertainment Corp	Cedar Fair LP	4098	Pending	U.S.	U.S.	Resorts/Theme Parks	1

Source: Candriam

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

• Sustainability Risk:

The sustainability risk refers to any environmental, social or governance-related event or situation that might affect the performance and/or reputation of issuers invested in.

Sustainability risks may be subdivided into three categories:

• Environmental: environmental events may create physical risks for the companies invested in.

• Social: refers to the risk factors linked to human capital, the supply chain and the way companies manage their impact on society.

• Governance: these aspects are linked to governance structures.

The sustainability risk may be specific to the issuer, depending on its activities and practices, but may also be due to external factors. If an unforeseen event occurs in a specific issuer such as a strike or more generally an environmental disaster, the event could have a negative impact on the performance. In addition, issuers which adapt their activities and/or policies may be less exposed to the sustainability risk.

• Equity risk:

Some strategies may be exposed to equity market risk through direct investment (through transferable securities and/or derivative products). These investments, which generate long or short exposure, may entail a risk of substantial losses. A variation in the equity market in the reverse direction to the positions can lead to the risk of losses and may cause the performance to fall.

• Counterparty risk:

OTC derivative products and/or efficient portfolio management techniques may be used. These transactions may cause a counterparty risk, i.e. losses incurred in connection with commitments contracted with a defaulting counterparty.

• Derivative risk:

Financial derivatives are instruments whose value depends on (or is derived from) one or more underlying financial assets (equities, interest rates, bonds, currencies, etc.). The use of derivatives therefore involves the risk associated with the underlying instruments. They may be used for purposes of exposure or hedging against the underlying assets. Depending on the strategies employed, the use of derivative financial instruments can also entail leverage risks (amplifying downward market movements). In a hedging strategy, the derivative financial instruments may, under certain market conditions, not be perfectly correlated to the assets to be hedged. With options, an unfavourable fluctuation in the price of the underlying assets could cause the strategy to lose all of the premiums paid. OTC financial derivatives also entail a counterparty risk (though this may be attenuated by the assets received as collateral) and may involve a valuation risk or a liquidity risk (difficulty selling or closing open positions).

• Arbitrage risk:

Arbitrage is a technique which consists in benefiting from the differences in prices recorded (or anticipated) between markets and/or sectors and/or securities and/or currencies and/or instruments. If such arbitrage transactions perform unfavourably (a rise in sell transactions and/or fall in buy transactions), the performance may fall.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.

This marketing communication is provided for information purposes only, it does not constitute an offer to buy or sell financial instruments, nor does it represent an investment recommendation or confirm any kind of transaction, except where expressly agreed. Although Candriam selects carefully the data and sources within this document, errors or omissions cannot be excluded a priori. Candriam cannot be held liable for any direct or indirect losses as a result of the use of this document. The intellectual property rights of Candriam must be respected at all times, contents of this document may not be reproduced without prior written approval. Candriam consistently recommends investors to consult via our website www.candriam.com the key information document, prospectus, and all other relevant information prior to investing in one of our funds, including the net asset value ("NAV) of the funds. This information is available either in English or in local languages for each country where the fund's marketing is approved.

Warning: Past performance of a given financial instrument or index or an investment service or strategy, or simulations of past performance, or forecasts of future performance does not predict future returns. Gross performances may be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact on gains. If the present document refers to a specific tax treatment, such information depends on the individual situation of each investor and may change. In respect to money market funds, please be aware that an investment in a fund is different from an investment in deposits and that the investment's principal is capable of fluctuation. The fund does not rely on external support for guaranteeing its liquidity or stabilizing its NAV per unit or share. The risk of loss of the principal is borne by the investor.