Q1 2022

U ACCESS (IRL) CHEYNE ARBITRAGE UCITS

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws.
The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- The first quarter of 2022 saw a broad selloff across risky assets, except for commodities. Both global equities and bonds were down mid-to-high single digits for the quarter, despite two-week rally at the end of March. Concerns about economic implications of the Russian invasion Ukraine, as well as the high levels of inflation and their impact on the pace of interest rates increases negatively impacted equities and bonds. On the equity side, the rotation from growth to value continued, as investors re-assess the level of multiples to be applied to high growth assets. In terms of geography, Europe and EM underperformed, while Japan and the UK outperformed.
- Equity volatility remained relatively high during the quarter, as investors tried to grasp the effects of the drastic sanctions, and the effects of higher commodity prices and supply chain disruptions on the economy. On the fixed income side, the strong shift in central bank policy as a result of persistently high inflation and strong economic data led to a continuation of the flattening of the yield curve. Some parts of the curve even inverted which could suggest we are heading towards a recession.
- As described more in detail below, the current market environment provides a compelling set of opportunities for our U Access (IRL) Cheyne Arbitrage UCITS fund, which is an arbitrage strategy with a yield component extracted from both merger arbitrage and mixed arbitrage opportunities. This solution offers alternative sources of yield to traditional bonds with limited duration and has historically shown low correlation to traditional asset classes.

Sources: UBP, Bloomberg Finance LP, BofA Merrill Lynch

Performance Review

- For the first quarter of 2022, U Access (IRL) Cheyne Arbitrage UCITS posted a return of +2.85% (Class C EUR, net of fees). Annualized deals spreads (LIBOR adjusted) were at a representative level of 7.1% in 1Q22 vs. 5.1% in 4Q21. Contributing to the widening of spreads in 1Q22 were (i) the obvious geopolitical worries and the associated market weakness (ii) an increase in regulatory risk and timing uncertainty (iii) expectation of higher interest rates to the extent that it is delaying capital deployment.
- We believe that the good health of the M&A markets will continue in 2022. While volumes should be down from the record levels recorded in 2021, the same supporting trends will continue to be at work and result in an elevated level of deal activity. Interestingly, global M&A activity was only down 15.6% y-o-y helped by a remarably resilent US market.

  On the positive side, the top three contributors during the quarter were Xilinx, Zinga and Z-Energy ltd. The top contributor to the quarter’s performance was a Merger Arbitrage position in Xilinx as the AMD acquisition was finally approved by the Chinese regulator (SAMR). As often, it was only cleared after the Chinese authorities extracted numerous benefits (Supply agreements, technology transfers...) as quid pro quo to their agreement.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

- The second largest contributor to the quarter's results was the Grifols share class position. The spread narrowed as it was speculated that the company was a takeover target. Should a bid materialise, the by-laws of the company oblige the bidder to pay the same consideration for all classes of shares. Given that the B-shares trade at a 35% discount we would realise the entirety of the spread in the event of an offer for the company. Even in the absence of a bid, we believe that the company will have to fudge it two classes of shares to reduce their leverage. In this scenario we see 15% upside. With 15-35% upside, less than 5% downside and no beta, we see the Grifols share class position as an attractive risk reward proposition.
- The third largest contributor to the quarter's returns was the merger Arbitrage position in Zynga. The spread considerably narrowed from its initial levels as TakeTwo (the acquiror) received the nod from the US antitrust authorities. We see little regulatory hurdles left ahead of the Q2 vote.
- On the negative side, the top three detractors over the quarter were the Hitachi Metals position, Afterpay, and Activision.
- The first detractor to the quarter earning was the Hitachi Metals Merger Arbitrage position. The spread widened as there was some press reports that the delay in obtaining clearance in China was linked to an unrelated ongoing legal dispute in China. This has now been denied by the companies but more importantly we think it should have little impact on the spread. The terms of the contract are very strong, and China is only around 10% of the company revenues. So, it is probable that Bain would have to close around the Chinese unit if there was a politically motivated delay in obtaining clearance.
- The second detractor to the period earnings was our Merger Arbitrage position in Afterpay ltd. We decided to cut the position as the Reserve Bank of Australia made a referral to the Australian treasury to change the treatment of the customer costs in the services provided by the company. While generally, the adverse effects of a change in the regulatory environment are carved-out in the DMA, the language was vague in this case.
- The third detractor to the quarter's return was a Merger Arbitrage position in Activision. The spread to the offer terms widened as the Antitrust Authorities rhetoric against FANGS amplified. We think that it will be very difficult for the FTC to articulate a case against Microsoft as we think that neither horizontal or vertical theories of arm would stand in a court.

Portfolio Activity

- U Access (IRL) Cheyne Arbitrage UCITS focuses on merger arbitrage and mixed arbitrage. At the portfolio level, the overall exposure of the book has now normalised as the team has selectively reinvested in new positions and increased the size of existing positions.
- In order to contain the risks caused by irrational retail participation (see above), the team has reduced the exposure to Share Class and Holding Arbitrage. This seems particularly adequate as the PM believes that the Merger Arbitrage and SPACs opportunity set are particularly attractive at the moment. Merger arbitrage now accounts for seven tenth of the portfolio's exposure.
- The Portfolio's exposure to SPACs is based on the fact that the team is currently able to buy equity optionality cheaply. As a reminder, a SPAC is an investment vehicle that enables a sponsor to raise capital via an IPO ($10 standard) with the purpose of acquiring a private company and taking it public. The cash raised in the IPO is subsequently held in a trust until the shareholders validate an acquisition in a vote.

- The arbitrage opportunity arises from the fact that shareholders have the option to redeem at the time of the vote and recoup their initial investment. Practically, the team will wait until an acquisition is announced. If the acquisition is creating value, the SPAC will trade above $10 and it will be sold prior to the vote. If the acquisition is perceived poorly, the team will simply redeem the shares and recoup $10.
- In terms of positioning, the investment team continues to favour deals with robust contractual protection. In the early part of the quarter, we actively curated the portfolio from positions that were either exposed to the Ukrainian situation or had DMA that did not protect them enough in the eventuality of a worsening of the conflict. This discipline contributed directly to the quarter performance. We also limited the fund exposure to long dated Sponsor deals as we are worried that rapidly raising rates could hurt the refinancing market and consequently increase the probability that these transactions could fail.
- At the end of December, there were 30 active Arbitrage Strategies in the portfolio. The merger arbitrage portfolio had 27 investments while the mixed arbitrage strategy was made of 3 distinct positions including the SPAC book. Note that the SPAC book itself is a diversified strategy made of 120 different units.

Outlook

- Deal flow has continued unabated in the fourth quarter with significant contribution from Private Equity buyers. At about $3.4tr at year end, 2021 is at all-time highs. Goldman Sachs analysts expect the acceleration to continue due to still-solid growth, attractive funding costs, record levels of capital & elevated CEO confidence.
- Given that M&A as a percentage of market cap (5%) is still far below the long-term average of 6% and prior cycle peaks of 8-10%, the bankers forecasts sound right. This assumption is supported by the fact that large transactions are well represented in the mix as it indicates that boards rooms are particularly bold now and the financial system healthy. Remarkably, Blackstone and Brookfield alone have announced $58Bn in the first three months of the year.
- As a matter of facts, US M&A continued at a reasonable pace in 1Q22 with fewer yet larger deals than in 2021. Financial sponsor deals proliferated, with their contribution reaching near record levels. Activity skewed strongly to large-size deals (>$5 billion). Sector balance improved materially based on deal count, but it was imbalanced by value. Cash use increased to historically high levels. Deal premiums remained high, especially for non-strategic and all-cash strategic deals, yet valuation multiples declined. Acquirer price reactions improved. Acquirer vote frequency declined significantly. Acquisitions by non-US acquirers decreased to historically low levels.
- In terms of sector focus, we are of the view that Technology, ESG and defensive transactions will remain the main themes driving M&A in the boardroom. Recently, we also saw the first signs that consolidation was accelerating in some corners of the “new Economy” (Cybersecurity, 3D-Printing, Cloud services). It is also likely that the Biden administration will continue to have a critical stance towards further consolidation in those sectors. In particular, “Big Tech” could also see an increase in regulatory pressure as bi-partisan support (Howley, Klobuchar) is emerging to stop “predatory M&A” from the FANGS.
- The Private Equity industry should continue to play a front runner role in prolonging the current deal bonanza. In a recent report, Bain estimates that the industry is sitting on a $3.3Tr war chest. This reinforces our viewpoint that the activity of sponsors should continue unabated from their current levels (40% of M&A activity year-to date which is a 20-year record).

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- In Europe, M&A activity is unsurprisingly sharply down (-60% y-o-o). The vast majority of the new deals were originated in the UK. We expect that any resolution in the Ukrainian conflict would be followed by a sharp rebound in new deals announced.
- Given the quality of the microstructure of the Merger Arbitrage market (High number of deals, large spreads) in the recent period, the investment team believes that next twelve months will continue to provide a supportive environment for the strategy.
- Looking at mixed arbitrage, the share class and holding spread arbitrage positions left in the portfolio all present extremely attractive risk-reward ratios. The overall gross size of the exposure to these sub-strategies as well as each single position has been reduced. This is to take into account the increase in volatility in the market but also to make room for the currently superior opportunity offered in merger arbitrage spreads and SPACs. A key differentiator between the attractiveness of the two strategies lies in the visibility on the duration of merger arbitrage spreads. In other words, the merger arbitrage and SPACs strategies allow the team to associate a duration with each investment.
- At the time of writing, the portfolio offers a yield-to-maturity of close to 4.5% in EUR with an associated duration of 4.2 months. To put things in perspective, if the deals in the portfolio all close as expected and accounting for a reasonable contribution from the mixed arbitrage book, the gross fund performance could be comfortably in the zone of its performance objective for the year.

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