Mainberg Special Situations UCITS: Mispriced Optionality

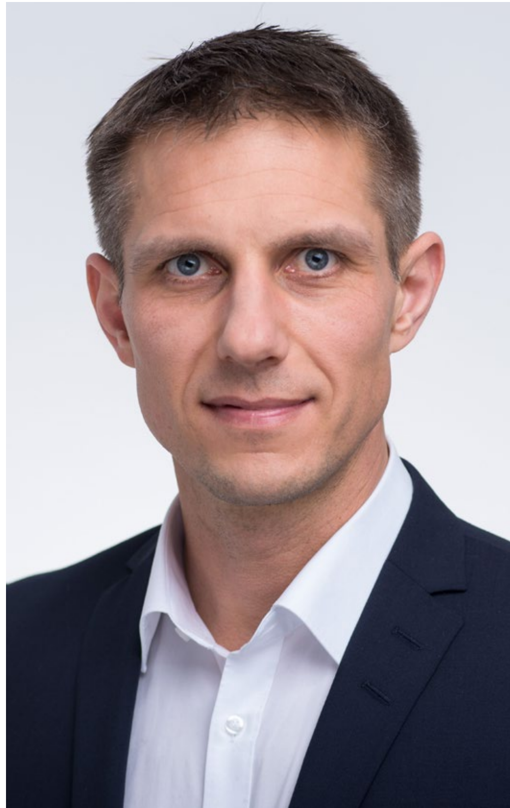
Asymmetric risk/reward in M&A arb and back-end deals

HAMLIN LOVELL

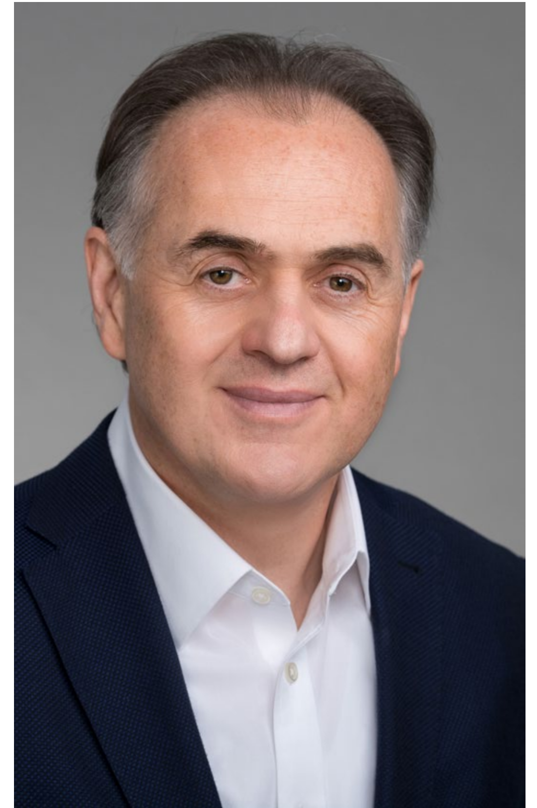
Mainberg Asset Management invest throughout the life cycle of post-announced corporate M&A deals, but generally have around half of the strategy in a specific category of special situations, where minority shareholders can create a sort of synthetic call option by holding out for higher offers while retaining the option to accept the initial offer, and often getting paid a respectable dividend in the interim. The subsequent opportunities are usually determined by a subtle and nuanced blend of legal procedures and valuation appraisals, rather than equity markets per se, which adds to the diversification benefits of the strategy. These opportunities are mainly found in German speaking European countries like Germany and Austria, as well as in Scandinavian countries, but other onshore or offshore domiciles that respect minority shareholder rights can also be invested in.

Mainberg was co-founded by Rudolf Ferscha and Dr Robert Hillmann. Ferscha, originally a corporate finance lawyer, worked for more than a decade in derivatives and investment banking in London and Frankfurt, where he served on the management board of Goldman Sachs in Germany, before joining the executive board of Deutsche Boerse and serving as CEO of Eurex, then the largest futures and options exchange in the world. Hillmann is an academic and expert on company valuation, who has taught it and has an intimate understanding of the valuation methodologies used by regional and national German, Austrian and other European courts. Mainberg has an internal database and institutional memory documenting all deals since the emergence of the current minority shareholder regimes in the late 1990s, including technical details and supreme court decisions. Thus, the main focus of the Mainberg team, which also includes two equity analysts and a marketing team, is on proprietary research and active trading, although some external providers are used, for example to pre-screen the circa 300 European M&A and related events per year which form the Mainberg investment universe.

The genesis of the strategy came after the GFC, when capital markets infrastructure investors Gledhow Capital Partners, founded by Ferscha in 2006, became wary of depositing with banks and sought a relatively safe liquidity buffer initially for cash associated with private equity investments in electronic trading platforms, ticketing and payment systems and other market infrastructure services like credit and ESG ratings. "We make high octane investments on the private equity side where there is a much wider range of outcomes and wanted strategies for parking short term money in a risk averse way as a capital preservation strategy. Our own capital, private equity capital awaiting capital calls, and the UCITS fund, all have been benefiting from the same level of safety and downside protection," says Ferscha, who in 2011 brought in Hillmann as Special Situations Research Partner to help develop this new strategy, ultimately also leading to the launch of Mainberg Asset Management in 2018.



Dr Robert Hillmann, Co-Founder, Mainberg Asset Management



Rudolf Ferscha, Co-Founder, Mainberg Asset Management

UCITS liquidity alignment

The diversified special situations strategy initially run at Gledhow Capital Partners generated a Sharpe ratio above two and an IRR of 11.4% gross between 2012 and 2018 while staying inside the UCITS diversification framework. "Very minor tweaks were required to wrap it in a UCITS structure, the Mainberg Special Situations Fund HI," says Ferscha.

The liquidity profile is somewhat paradoxical. At first sight, some of the back-end merger deals invested in might in one sense have a multi-year time horizon while awaiting a series of valuation appraisals and court judgements and reported trading volumes may be thin over this period since the holdouts are investing in anticipation of upside. It is not essential to hold deals until every event occurs, and in the interim, there are avenues of liquidity. "Domination agreement shares can be sold to other investors on the secondary market or put back to the acquirer, an optionality not widely appreciated. Squeeze-outs also provide a liquidity option. Therefore, conventional liquidity risk analytics based on historical volumes or stock exchange data understate liquidity by ignoring those put options," says Ferscha.

Stable returns and swift drawdown recovery

The UCITS, which launched in January 2019, now also has a three-year plus track record. It has maintained a steady return profile and recently received *The Hedge Fund Journal's* UCITS Hedge award for Best Performing Fund in 2021 and over 2 Years ending in December 2021, in the European Special Situations category, based on risk-adjusted returns. The strategy can incur some mark to market volatility but has historically bounced back very swiftly. Its deepest drawdown of around 9% was seen in Covid-March 2020, purely based on spread widening since there were no deal breaks. The dip, which was only one quarter of the 36% pullback seen in the DAX, was recovered very rapidly and fresh highs were made within a month. Mainberg ended 2020 up 7.35%, in line with their long run, through-the-cycle return target of 6-8% per year. Positive surprises can sometimes lead to this target being surpassed, and 2021 was exceptional with returns over 10% thanks to substantial appreciation in certain positions such as Amsterdam-listed Hunter Douglas, which has made about 200% in the 12 months since Mainberg entered the position.

Asymmetric return distribution

The range of returns on individual deals is of course much wider than on the fund and varies with entry points and interim events along the timeline. The strategy is asymmetric with respect to the original acquirer offer since valuation appraisals routinely result in a higher price. However, if arbitrageurs entered a position at a premium to the original offer, and there is no uplift upon appraisal, then a typically small loss could be booked: "Some cases can have a slightly negative return relative to our entry level, otherwise it would be a free lunch. We have also had deals with flat payoffs, which is fine given our primary aim of capital preservation. We can live with boring situations. We identify asymmetric risk/return with very limited downside risk and much more upside potential," says Hillmann.

While awaiting appraisals and other events, the base case return for minority/holdout shareholders in domination agreements is a fixed dividend of typically 3-4% per year, after a cut-off date. This regular income provides buoyancy helping to stabilize the portfolio, and in some cases the income could offset or outweigh any loss of entry premiums paid absent uplifts.

Ratchet mechanisms

Careful judgement is exercised in determining how much premium to pay at the outset: "Our entry levels for Germany and Austria deals are usually above the initial offer, in anticipation of bumps. Every case is different and the spread versus the original bid price will depend on deal terms and conditions, risks, and upside potential after the bid. Premiums can also be influenced by the acquirer's target percentage ownership. If a private equity firm want a larger percentage ownership, they may need to pay more. The last share is usually the most expensive and the series of preceding events and court appraisals resembles a ratchet mechanism, where subsequent offers normally go sideways or up. This contains cheap embedded optionality. You could not buy an American option and get paid a regular income for it," says Ferscha.

Picking deals

Mainberg are quite selective about which merger deals and back end special situations to participate in. "Of 200 takeovers and 100 back-end situations each year in the target markets, we typically have 30 positions at any time. We have a rough negative selection matrix, which avoids politically sensitive deals, those with competition law issues, some in pharmaceuticals etc, and others based on more detailed work. We avoid high risk and binary deals. We would rather sleep well than eat well," says Ferscha. On the back-end side, "Deals driven by strategic industrial logic rather than financial buyers often have more potential to benefit from increased outcomes through higher valuation appraisals," says Hillmann.

Trading around the full deal life cycle

Mainberg do not exclusively invest in front- or back-end situations for various reasons. "It is sometimes worthwhile to get in at the start and see how the situation evolves, as was the case with Hunter Douglas. The front-end trade entries are significantly informed by the potential for back-end value. We want to define upside potential based on applicable rules and regulations at a very early stage, as there may be multiple opportunities to trade around spreads over the years, through the value chain of the takeover, domination agreement and squeeze out. We would miss opportunities if we only focused on one stage," says Hillmann.

Mainberg avail of multiple opportunities to trade in and out of deals over years or decades as the value chain evolves, with milestones including competition regulatory approvals, domination agreements and guarantee dividend payments. "When the relative value is overpriced, and general market sentiment is positive, we become natural sellers. When it is underpriced, we may go back in or add to a position. Pricing becomes more efficient as it gets closer to the back end because by then the free float is mainly owned by specialists or generalists with deep knowledge, and the potential for increased valuations is largely priced in. Our core competence is to identify and quantify the upside as early as possible, and earlier than other participants, based on our 20 years of experience, reviewing all deals since the late 1990s," says Hillmann. "The Audi/VW takeover from the 1970s was one of the longest running, with the squeeze out only executed in 2021, partly because the listing was needed for an ongoing executive incentive program," says Ferscha.

Portfolio construction

The stage of the cycle is one dimension of diversification. "Portfolio construction aims for diversification on several dimensions: such as industries, free float, size of company, and stage in the M&A value chain. Our diversification works like watertight compartments on an ocean-going vessel – it supports the buoyancy of the overall ship," says Ferscha. Mainberg can invest in small or micro-cap deals and can build more meaningful positions than multi-billion-dollar funds, which sometimes deploy $100 million or more in a single deal. That said, Mainberg do not want small caps to become a major part of the fund: "Our UCITS fund offers investors daily buying and selling and we therefore pay close attention to liquidity".

Assessing deal break risks

Mainberg have had very few deal breaks: "Though Covid has sparked renewed interest in Material

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Adverse Change (MAC) clauses, we were not exposed to deals that broke for this reason," says Hillmann. Deal break risks seem very remote for back-end deals, where most of the target has already been acquired: "A bankruptcy of the target company could scupper a deal, though we have not seen this happen. A bankruptcy of the acquirer would not necessarily cause losses for arbitrageurs, since the banks who guaranteed the takeover in the offer document would then be on the hook, as we saw in one case in the GFC. Ultimately, the bank guarantors would also need to go bust for some sorts of deals to break," says Hillmann.

Legal and accounting analysis

Many of the rules applicable to special situations today have been introduced since the late 1990s. "German speaking countries have developed these rules and regulations over the last 30 years, and we have been actively monitoring their evolution over the years. The granularity of analysis drills down to not only the individual 16 Federal states or Laender in Germany and their respective high courts, but also monitors individual chambers, who may be predisposed towards certain valuation approaches, country risk premiums or discount rates. There are many additional granular and specific insights," says Ferscha. Valuation analysis in the sector comes mainly from the Big Four accounting firms and some regional accounting firms in Germany. It is not clear whether the equity market correction in the first half of 2022 (which has had the most marked impact on richly valued US "growth" stocks) will have any impact on DACH valuation appraisals, which are quite slow moving.

In most cases the local state court makes a final decision, though Mainberg might have already exited before then. "On rare occasions of flagrant and gross violation of property rights, cases can reach a supreme court such as Germany's constitutional court in Karlsruhe," says Ferscha. One such case is the long running saga of Kabel Deutschland. It was bought by Vodafone in 2013 for EUR 84.50, and Elliott Advisers commissioned a special audit report which led them (as well as DE Shaw and UBS O'Connor) to receive a higher price of EUR 103, in return for not pursuing any further legal action. However, the revelations in the report sparked Mainberg's interest in potential for a further bump: "The 800-page report was released to all shareholders in late 2020, revealing a valuation of EUR 120 against the original offer of EUR 84.50. We reckon that the final price could be even higher than EUR 120. We are amongst the few remaining participants in this case," says Ferscha. "The report is quite damning of the company's decision-making process. It even argues for a criminal investigation and opens several avenues for an upwards review," he adds.

Occasional activism

Mainberg is normally a passive investor. "We have no intrinsic aggression towards management and boards," explains Ferscha, whose own background is in managing and overseeing companies, and who currently also serves as chairman of the supervisory board of Amsterdam-listed market making firm Flow Traders, one of the highest volume securities trading firms in Europe. "We generally prefer to work cooperatively with companies and invest where we appreciate the management. Also on special situations we are certainly not litigators by choice and only occasionally pursue an active stance where necessary to realise full value," explains Ferscha.

One such case was Austrian firm Constantia Packaging AG, where Gledhow Capital Partners were the biggest free float investor into the squeeze-out and made use of a discovery lawsuit in the New York court system. "The acquirers who bought 75% of the firm (One Equity Partners, then a JP Morgan private equity subsidiary) wanted to squeeze out the minorities at a very low valuation (of EUR 47). We invested in US discovery proceedings to ensure that the internal discussions at One Equity Partners were disclosed, revealing their original intention to spin off parts of the business, such as AMAG, which would have increased the valuation. This led to big increases in the squeeze out payment," says Ferscha. Ultimately an extra 35 Euro per share, 75% above the initial offer, was paid to minority shareholders, and has been ranked as the highest ever additional payment adjudicated in Austria.

Beyond the DACH countries

Generally, jurisdictions are assessed on a case-by-case basis. "We focus on countries with an established history of a good judicial system that is reliably diligent in looking for fairness for minority and other free float shareholder rights," says Ferscha.

Germany and Austria are the largest two markets for the strategy, but also elsewhere in Europe extraordinary opportunities can be found. "Amsterdam-listed Hunter Douglas not only traded slightly below the initial offer of EUR 64, but ultimately tripled in price, with the first bump up to EUR 82, as it turned out that a much higher offer of EUR175 was needed for a PE firm to obtain control," says Hillmann. The relatively unusual corporate jurisdiction of Curacao might have deterred some investors. "We were prepared to research and fully understand it, partly because we took comfort in Amsterdam's Supreme Court being the ultimate venue," says Ferscha.

In another case, Mainberg had confidence in a Croatian deal, partly because Croatia's capital markets laws are based on the Austrian rules. This is one of several Eastern European countries Mainberg has invested in. Mainberg has also occasionally looked at SPAC deals, which might be incorporated in other domiciles such as Luxembourg.

Other triggers for valuation appraisal

Changes of corporate entity legal form, e.g., from real estate investment trust (REIT) to normal corporations can sometimes trigger an offer or valuation appraisal. "These under-researched areas are ideal for us to use our speed advantage," says Hillmann. Some special situations investors also trade spin-offs, but Mainberg does not on a standalone basis. "There might be a spin-off associated with various M&A deals, but spin-offs alone are not traded because they are insufficient to derive a hard share price impact," says Hillmann.

Plain vanilla aspects

In terms of legal and valuation analysis, the strategy is complicated and sophisticated. In other respects, in terms of balance sheet, instruments used and fund structure, it is much more plain vanilla.

Only publically announced deals

Mainberg only invests in publically announced deals, as the lure of rumour mills is considered an unattractive threat to integrity. Mainberg do not play reverse merger arbitrage deals wagering on spread widening or deal breaks. If a spread is not attractive, they would simply avoid it or exit.

The strategy is not leveraged and usually sits on about 5% cash to retain some dry powder, though this can sometimes be higher after deals close or cash compensation is received.

Mainberg implement the strategy using common equities. Though some deals could be played through credit or convertibles, Mainberg are also of the opinion that equities have been amongst the safest investments over long periods, particularly those including wars or currency reforms.

Retail and institutional investors can invest in the fund directly or through savings plans. The Mainberg UCITS is a German UCITS, which sits on the well-known Hamburg-based HANSAINVEST platform. The platform, and other service providers such as KPMG for audit and MSCI for risk reporting, means that the core team of five people can focus on investing.

The first half of 2022 has been very turbulent and game changing for some investment strategies, but it has been business as usual for merger arb and back-end deals, which still have the potential to provide both steady returns and positive surprises against a more uncertain and volatile geopolitical, economic and financial market backdrop. **THFJ**