Mainberg: Compelling Back and Front-End Deals

Capitalising on higher interest rates

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The Mainberg Special Situations UCITS fund, which launched in January 2019, now has a five-year plus track record. It has received *The Hedge Fund Journal's* UCITS Hedge award for Best Performing Fund in the European Special Situations category, based on risk-adjusted returns over various single and multi-year periods, on several occasions.

With 2022 and 2023 having been relatively subdued years for performance for many funds in the space, Mainberg utilizes the evolving dynamics of both back-end and front-end deals to lay the foundation for a stronger opportunity set going forward. Higher interest rates have had specific impacts at different stages of the life cycle for the post-announced corporate M&A deals that Mainberg trades.

Back-end premium compression

For domination agreements, mainly in German-speaking Europe, higher rates have raised the base case annual return by increasing the de-facto put option strike price inherent in stocks under domination agreements, currently by 8.62% pa, creating a kind of ratchet mechanism, which continuously adds interest to the put level. Higher rates can also be one force reducing valuations in multi-factor models and have contributed to some erosion of premiums over initial or prior offers. Investors pay a premium over the last offer price for several reasons: they expect one or more higher subsequent offers, they allocate value to expected upward valuation appraisals and/or other legal processes, possibly competing bids, and progressively higher squeeze outs. In the meantime, they earn a guaranteed dividend, which is subject to upward-only reviews by courts.

"Premiums on the back-end deals have somewhat compressed, and in some cases all but disappeared, creating an attractive buying opportunity," explains Mainberg co-founder, Rudolf Ferscha.

The offsetting impacts of higher interest rates means that Mainberg's (historically surpassed) long term 6-8% annually through the cycle return target remains in place.

The risk/reward profile has, however, become more asymmetric and quasi-bond-like from a cash-flow perspective, because a higher proportion of this anticipated return is guaranteed through the fixed annual compensation payments. Mainberg views the back-end deals as being less risky than a credit strategy that carries default risk and insists that capital preservation is their primary goal. The origin of the strategy was as a temporary home to park capital related to private equity deals, with no tolerance for capital attrition.

Dr Robert Hillmann, Co-Founder, Mainberg Asset Management

Rudolf Ferscha, Co-Founder, Mainberg Asset Management

In early 2024, Mainberg co-founder and portfolio manager, Dr Robert Hillman, judges that the premium compression has now been digested, leaving premiums at historic lows over initial or prior offers, which become a put option underpinning the prices. Going forward, Hillmann anticipates "an 8.62% annualized increase in the guaranteed strike price of the put options in addition to the guaranteed annual compensation payments, which can be viewed as *de facto* fixed dividends. This now provides a buffer that could absorb some compression of the modest remaining premiums". For stocks trading at low premia, the sum of these return elements has more than doubled since we last interviewed Mainberg in 2021, when the base case return for minority/holdout shareholders in domination agreements was a fixed dividend of typically 3-4% per year, after a cut-off date.

Hence the overall allocation to stocks benefiting from domination agreements has increased from a historically typical 30-35% to just under 50%. But it is not a pure buy and hold trade. Mainberg does also trade around individual back-end deals, over years or decades as the value chain evolves, with milestones including competition law and regulatory approvals, domination agreements and guarantee dividend payments.

Front end deals

In other markets such as the UK market, Mainberg has not observed these sorts of "free options" on the back-end deals but would rather look at front-end deals where bidding wars could lead to "bumps".

The impact of higher interest rates on front-end deals is clearer cut: they should increase overall returns, which have historically been a variable spread over and above the risk-free rate.

Deal break risk

Front-end deals have far more deal break risk than the back-end ones, where it would be extremely rare for a bidder to renege on an offer after the majority of a company has already been acquired.

Mainberg's safety-first mentality has avoided all bar one deal break situation since inception. "We apply an initial negative selection matrix, which avoids politically sensitive deals, those with competition law issues, some in sensitive industries like pharmaceuticals etc., and others based on more detailed work. We were not invested in deals that broke due to material adverse change clauses during COVID in 2020," says Hillman.

Mainberg also avoided high risk and binary deals, such as the Microsoft/Activision deal, which

was delayed by a UK investigation, but ultimately approved. "This was far too binary for us. We would rather sleep well than eat well, so are happy with deals paying a predictable 6-8 percent. We are keen to make positive returns even in a not-so-great year and can live with less than shooting the lights out in a stellar one," says Ferscha.

Mainberg remains cautious about regulatory risk, especially in a climate of heightened geopolitical tensions with sanctions, countersanctions, national security vetoes and so on. The closest the fund ever came to a deal break was back in 2021 and involved Taiwan's Global Wafers bid for German wafer producer, Siltronic. In Q3 of 2021 it became apparent that there would be a delay to the required approval by Germany's Ministry of Economic Affairs despite the US, UK and Japan already having approved it. "The ministry did not give any material reasons for not deciding within the deal deadline, and in later parliamentary questioning only referred to late Chinese antitrust approvals having impacted its ability to decide within the deal deadline," says Ferscha. "This had been unprecedented. There were no sanctions on this technology, which is simply put a raw base product for chips." As the deal uncertainty continued for several months whilst the market was awaiting a decision, the fund traded out of most of the position over time and could avoid a marked drawdown. Still, this lesson heightened Mainberg's aversion to politically sensitive deals. Mainberg did not see any hope of the bid being salvaged. "Though the bidder could in theory return with another offer, we doubted whether they would want to do so absent a substantive explanation for the approval not having been given," says Ferscha.

Regarding US deals, Mainberg are much more likely to be invested in the target of a US bid, than in a US target where a foreign buyer might be vetoed.

Expanding jurisdictions for front end deals

Historically, Mainberg has invested mainly in German-speaking European countries like Germany and Austria, as well as in Scandinavian countries, but these only provide a limited number of back-end and front-end deals satisfying their exacting criteria. Therefore, Mainberg have been expanding to additional jurisdictions such as Benelux (Belgium, Netherlands, and Luxembourg), France, Spain and Portugal. They already have some experience of investing in some of these markets, for example generating outsized returns from the Hunter Douglas private equity deal under Dutch law. "There are several European jurisdictions with attractive protections for non-controlling shareholders. In several of those we have been building up our professional network and are working with specialized law firms and additional analysts with the right knowledge base," says Ferscha. Mainberg view

> "We would rather sleep well than eat well."

themselves as a research-based organisation, and have outsourced many functions to professional partners, with Hansainvest providing fund issuance and administration services, MSCI covering risk reporting, and Capatico distribution and marketing services. "Our research team is at the core of the value creation, and we only ever rely on our own research for investment decisions, so we want to make sure we keep focused on what only we can do," he adds.

In early 2024, Mainberg had just 25% in front-end merger arbitrage, but this sleeve could grow much bigger as market coverage grows. "It is a larger universe now, which can also accommodate higher allocations," says Ferscha.

Extra special cases

If the broad average return expectation is 6-8% per year for back-end deals, and possibly more for front-end deals in the current interest rate climate, some extra special cases can generate double digits in a matter of months. (It is not meaningful to annualize this into a triple digit IRR, because they are by their nature one-offs and capital cannot be continuously redeployed at the same rate of return.)

For instance, Mainberg sometimes trades in idiosyncratic situations, where payoffs depend on very specific case law, usually from various German High Courts. "Only participants familiar with this could come to the right conclusions. In a recent case we made 15% in a very short period between the announcement of the squeeze out and the cash compensation fixing," says Hillman.

Another example was a small position in Genussscheinen, translated to "participation certificates", which created a technical arbitrage. "A bid appeared for this instrument alone, but not for the general stock of the company. There were different opinions about how to calculate the redemption price, and some uncertainty and confusion. We were confident in knowing how to calculate it and profited from the position," says Hillman.

This is one of many examples where somewhat opaque markets play into the hands of those who are close to them. Mainberg's proprietary research team has documented deals in various jurisdictions and chambers since the current minority shareholder regimes evolved in the 1990s, and consequently can often make faster decisions than other participants.

Mainberg has very occasionally entered into bilateral trades with a main shareholder, where they seek their view of a fair price without necessarily taking the trouble to go public with any activism or complaint or demanding that the offer be extended to any other shareholders. Public activism would be a very rare occurrence for Mainberg.

Vodafone/Kabel free option

Many of the back-end deals are now virtually free options, and there is also a literally and absolutely free option in the fund. This is a pocket of optionality that may seem very quirky for those from English common law countries. The long-running Vodafone/Kabel case might conclude this year or may return to its original court. Mainberg still holds out hope of an offer in excess of EUR 120. The fund has already received the proceeds from having been squeezed out but retains an assessment right, off balance sheet, which is by default valued at zero. Both existing and new investors get exposure to this asset. "This may seem surprising from an Anglo-Saxon perspective, but it is normal practice for auditors and regulators in Germany. In the Anglo-Saxon world, people would rather be roughly right than exactly wrong, whereas in Germany valuations usually err towards the side of caution," explains Ferscha. "These sorts of exposures are also not easily transferable, so particularly tough to value," he adds.

Outlook

It is not entirely fair to compare Mainberg Special Situations to a traditional plain vanilla merger arbitrage strategy, since the strategy trades unique deal types and names, the correlation is quite low and there is only limited overlap in the sleeve trading traditional front-end merger arbitrage deals. Beyond a mix of back and front-end deals at different points in the M&A value chain, overall portfolio construction maintains several dimensions of diversification: such as industries, free float and size of company, with some controlled exposure to small and medium size firms.

However, a broad-brush comparison may help to underscore why now may be an opportune entry point. Historically, the strategy has outperformed the HFRI Liquid Alternatives Event Driven Merger Arbitrage Index by between 2% and 7% per calendar year, but 2022 and 2023 were the only two years when the strategy beat that index by less than 1%. If the reasons discussed – including further back-end premium compression – are unlikely to be repeated, 2024 and future years should become vintage years for the strategy. **THFJ**