# Gabelli Merger Plus+

**GMP seeks to generate uncorrelated, absolute returns through investing in announced mergers on a global basis...**

Update
10 November 2020

## Summary

Gabelli Merger Plus Trust (GMP/GMPP) aims to provide uncorrelated absolute returns by investing in announced mergers in order to earn the spread between the deal price and the market price of the acquired company. Whilst investment is predominantly through equities or instruments tied to equities, GMP is seeking to benefit from the share price upside offered by the risk premium attached to announced deals. As such, returns will not typically be driven by wider equity market moves. The trust aims to pay a 5% dividend yield on NAV.

Although this trust was launched in July 2017, Gabelli Funds has managed dedicated funds with this approach since 1985. However, as we note under **Performance**, the lower interest rate environment (which would typically see a lower spread attached to proposed deals) has negatively impacted M&A strategies.

A widening discount has negatively impacted shareholder market price returns despite relative NAV resilience. As we discuss under **Discount**, the board had initiated a share buyback programme earlier in 2020, but the discount remains stubbornly wide at c. 22.4% (as at 28/10/2020).

**Dividends** have been in line with the proposed payout of 5% since launch on the starting NAV. However, with the trust moving to a sizeable discount, the historic yield on GMP is now c. 6.5% (as at 26/10/2020). A sterling quote for the shares was launched in summer 2019, and trades under the symbol 'GMPP'; this is aimed at improving trading volumes and liquidity with the ultimate aim of broadening the shareholder register in the UK.

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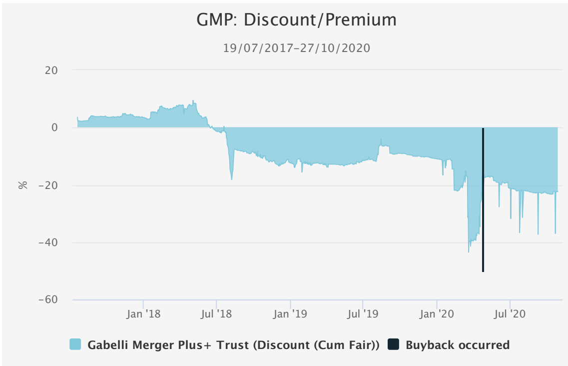
### Key Information:

| | |
|---|---|
| Price (p) | 0 |
| Discount (%) | -23.5 |
| OCF (%) | 1.47 |
| Yield (%) | 6.5 |
| Gearing (%) | 0 |
| Ticker | GMP |
| Market cap (£) | 76.4m |




## Kepler View

Uncorrelated, or at the very least lowly correlated, NAV returns look an attractive proposition in the current environment. The low interest rate environment of recent years has been challenging to absolute returns, but any economic recovery could well see deal activity pick up, as has often been historically observed following sharp recessions. At this time the low cost of capital is also a potential driver for deal-making.

Against this must be weighed the potential headwinds to M&A activity in general; since c. 1978, received wisdom in the US in particular has held that consolidation activity cannot be held to be deleterious to the public interests if it lowers consumer costs. Yet this is an interpretation, not a fact, of competition law, and there are some indications that US politicians may be starting to re-evaluate antitrust jurisprudence. If this comes to fruition, it could inhibit overall deal activity and likely reduce the risk premiums available to M&A strategies.

Yet 'if' is the key word in this. The signs of political shift are tentative, and certainly not mainstream in either main party yet. Favourable jurisprudential attitudes to mergers have, if anything, accelerated since 2008–09.

GMP's discount is optically attractive, but thin trading volumes mean the discount narrowing should not be taken for granted. More pertinently, dividends have been consistently maintained, and should remain a largely uncorrelated source of income.

| BULL |
|---|
| Low to no correlation to wider equity markets |
| Should benefit from a rising rate environment, unlike most conventional asset classes |
| High dividend yield, at c. 6.5% |

| BEAR |
|---|
| Governments and central banks may try to suppress interest rates |
| Thin trading volume and concentrated ownership structure a barrier to discount narrowing |
| Potential shift away from favourable regulatory regime for M&A could pose strategy headwinds |

# Portfolio

Gabelli Merger Plus+ Trust (GMP/GMPP) seeks to provide investors with both capital appreciation and income through investing in companies subject to accepted merger/acquisition bids. GMP targets a yield of 5% p.a. of the average quarterly NAV (to be paid quarterly) and capital appreciation. The trust has a dual share class structure, with GMPP the sterling market quote.

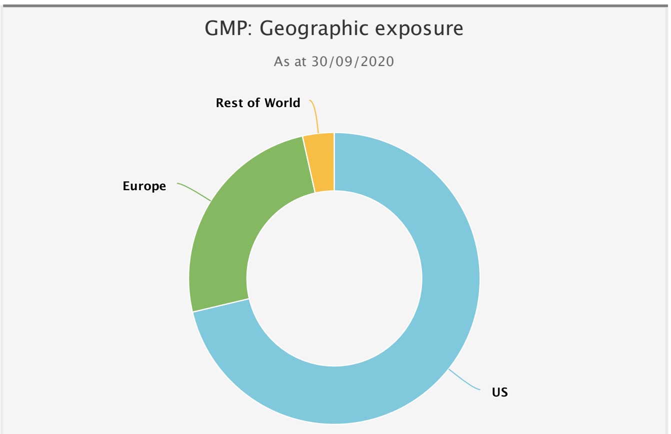
The managers utilise a 'merger arbitrage' investment strategy, seeking to profit from the spread between the share price of a company which is the subject of an agreed acquisition or merger offer, and the price at which the merger or acquisition has been agreed. Although an accepted bid will typically raise the share price of the target company to a level near the agreed price, there will ordinarily remain a relatively small residual spread between the share price and the agreed price, reflecting investor wariness around potential deal completion and the anticipated time to closing. Typically the team operate with a target rate of returns for deal spreads of c. 300–400bps in excess of a three-month US Treasury Bill. At present this equates to c. 3.1–4.1% (0.1% plus the premium). Nonetheless, portfolio positions display a wide variation in spreads, and transactions perceived as facing greater risks tend to produce greater deal spreads (and thus returns) if completed.

The strategy aims to buy shares at a discount to an agreed purchase price. Accordingly, market directionality should pose very limited risk to returns, and risks are instead incurred on a deal-by-deal basis. In essence, the risk incurred is that the deal will not be completed for any of a variety of reasons, with potential obstacles including a lack of regulatory approval for antitrust reasons, or shareholders rejecting the deal. A deal that is renegotiated at a lower price can also present a risk to returns.

Interest rates are likely to be more pertinent to absolute returns than equity market direction. Spreads available on merger arbitrage trades reflect in part wider interest rates, as the risk premium attached to potential deal completion/failure will factor in the cost of risk-free returns. Interest rates also have implications for the underlying pricing of deals, but the relationship between interest rates and absolute returns generated by merger arbitrage (and GMP) is likely to be indicative, as opposed to determinist. Deals may be denominated as all cash, all stock, or a mix of stock and cash. In an all-cash deal, the managers take a 'long' position in the shares of the target company, seeking to earn as a gain the spread between the market price of the shares at the time of purchase and the purchase price offered.

The managers of GMP/GMPP typically, but not wholly, prefer to focus on friendly, strategic takeover bids, and historically have had a preference for cash bids. Investing globally, there is nearly always a ready pipeline of proposed M&A deals arising for the management team to sift through and select those they deem to offer the best risk/reward attributes. With much of the downside risk incurred arising from the potential for the lack of deal completion, a key consideration for the team is identifying those deals they believe are highly likely to succeed. This will encompass a range of considerations, including understanding the different risks posed from deals in different jurisdictions and the prevailing regulatory interpretations of merger activity. For this reason, whilst the strategy is in theory able to go anywhere on the globe, the team focus on deals in jurisdictions where there are demonstrably strong governance and clearly defined legal processes. Accordingly, a majority of the portfolio is likely o be in the US and GMP will typically be nearly wholly invested in the US and Europe – as illustrated in the chart below.

### Fig.1: Geographic Allocation




Source: Morningstar, as at 30/09/2020

In part, risk management (and aversion to deals which may potentially fail) explains the historic preference for friendly takeover bids over hostile takeover bids, with the managers noting that friendly bids have historically demonstrated high success rates. The converse is true of hostile bids.

Idea generation is sourced from observing proposed M&A activity from around the globe, monitoring proposed deals and feeding this into the Gabelli's proprietary 'Private Market Value with a CatalystTM' research methodology. The managers draw on an extensive analytical team to analyse regulatory risks, company-specific factors, any risks to financing of deals and the likely direction of shareholder votes, as well as the likely timeframe before returns can be realised. GMP itself has seven dedicated team members, plus the team are able to draw on the broader analytical insights from across the Gabelli organisation.

The sizing of individual positions follows a relatively systematic process, with initially relatively small position sizes built to greater levels as deals near completion (and risks to deal completion reduce, along with the potential subsequent return available).

The managers note that H1 2020 undoubtedly proved a challenging environment for identifying attractive merger arbitrage activity, with a 41% year-on-year decline in global M&A activity. With this decline in large part a result of the economic contraction and collapse in business confidence following the COVID-19 pandemic and associated policy responses, the managers see the potential for a recovery. In particular, policy responses to ensure the cost of capital remains low can potentially render acquisition activity attractive to financially strong companies looking to grow market share. The managers note that they believe the environment remains favourable to deal-making. They also note that for now the standard judicial interpretation of competition law – and standard bipartisan political position – remains to assume that, so long as no additional cost accrues to the consumer, no abuse of market position has occurred.

In any event, the managers continue to focus on risks on a deal-by-deal basis. US deals continue to offer a spread premium to typical European deals, in part courtesy of higher US bond yields.

## Gearing

GMP does not have any trust-level structural debt at present; however, the strategy itself deploys leverage as an inherent facet of the merger arbitrage investment process. Contracts for difference are employed in the place of cash equities on occasions where they can be deployed more cheaply and with greater liquidity than shares can. These allow the trust to be geared up and increase the total gross exposure, as the exposure they offer to the underlying asset is higher than the amount of cash held as collateral.

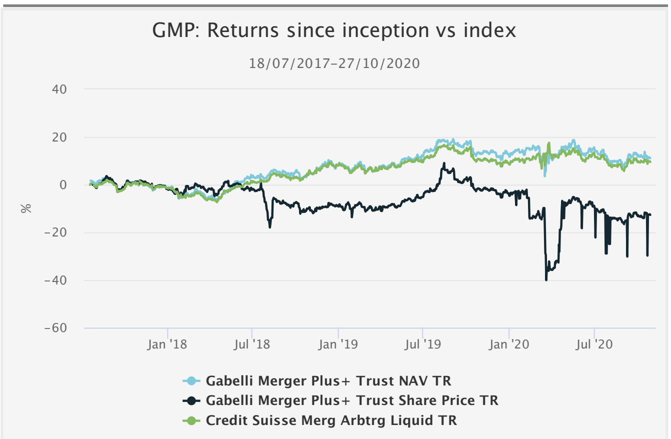
As at 30/09/2020, the gross exposure of GMP was c. 137%. However, some of this exposure includes short positions in stocks, and the net exposure at this date was c. 77.3%. The gross exposure is substantially below the maximum permitted level of 250%.

## Performance

GMP has, since launch, delivered NAV and share price returns of c. 11.1% and c. -12.7% respectively. Over this same period, the Credit Suisse Merger Arbitrage Liquid Index has returned c. 9.5%. Whilst GMP nominally sits within the Morningstar and AIC Hedge Funds peer groups, such is the diverse and eclectic array of strategies within this grouping that we do not think it serves any purpose as a comparator.

Whilst NAV returns have exceeded those of the comparative index, clearly a significant widening in the discount has impeded the returns to shareholders.

**Fig.2: Cumulative Returns Since Inception Vs Index**




Source: Morningstar

Over the 12-month period to 27/10/2020, GMP generated NAV and share price returns of c. -2.1% and c. -11.3% respectively, whilst the Credit Suisse Index returned -1.1% over the same period. Whilst deals such as Allergan's takeover of AbbVie proved beneficial to returns, delays to existing deals against a highly uncertain macroeconomic backdrop proved a slight headwind. Similarly, some deals within the portfolio were subsequently renegotiated at lower prices, but GMP experienced only a very few deal breaks (and those in small positions).

Despite this, NAV proved resilient to the wider equity market sell-off, though share prices were marked down. In the Q1 2020 sell-off, many investment trusts saw share prices marked down disproportionately to any actual selling pressures. This was because the lack of the presence of buyers in the market saw market makers mark down prices sharply in the hope of matching flows in stocks/trusts which are, often because of the complexity of the underlying strategy, generally thinly traded. We note that none of the notifiable shareholders were active as either buyers or sellers in this period.

The strategy is designed to be insensitive to wider market movements, except in so far as ebullient markets will perhaps be likely to see greater M&A activity. As can be seen in the table below, this has largely been true over the past 12 months to 30/09/2020 for GMP, despite the extreme volatility seen in global financial markets.

### $R^2$ To Major Equity Indices

| INDEX | R2 |
|---|---|
| FTSE All-Share | 0.09 |
| iShares Global Tech | 0.10 |
| MSCI ACWI | 0.17 |
| MSCI EM | 0.00 |
| MSCI Europe | 0.06 |
| S&P 500 | 0.17 |

Source: Morningstar, 30/09/2019 - 30/09/2020

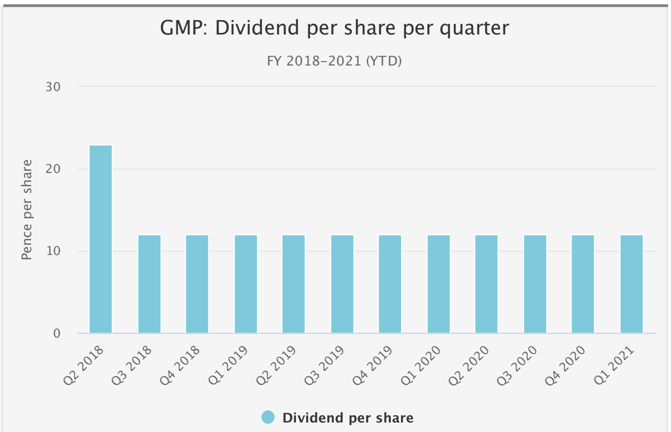
Part of the uplift available in merger arbitrage trades typically varies in line with the perceived risk-free rate of interest available, and so changes in bond yields impact the absolute level of returns the managers are likely to be able to generate. If we were to see higher interest rates in the future, and were this to negatively affect equity markets (particularly through the application of higher discount rates to valuation models), the strategy should remain relatively unaffected by equity markets whilst benefitting from higher interest rates.

## Dividend

GMP currently yields c. 6.5% on a historic basis (as at 28/10/2020). At launch GMP committed to pay out 5% of the average NAV over each quarter in a dividend, to be paid in January, April, July and October. This is paid from capital.

Distributions in the first financial year were 47 cents, amounting to roughly 4.7% of the NAV at launch. Thus far in the current financial year (2021), one dividend of 12 cents has been paid, in line with the previous financial year. As can be seen below, distributions have remained entirely consistent, barring a bumper first dividend payment (accounted for by the five months of trust operations from launch until the first distribution).

### Fig.3: Dividend Per Share




Source: GAMCO, The AIC

## Management

Gabelli Merger Plus+ is managed by Gabelli Funds, LLC (GAMCO). Based in Rye, New York, the Gabelli organisation collectively oversees $41bn in assets (as at March 2019). Mario and Marc Gabelli lead the firm's portfolio team, overseeing the implementation of the 'Private Market Value with a Catalyst' approach which Mario pioneered in the 1970s.

GAMCO was founded by Mario Gabelli in 1976 as an institutional research firm. It is now a publicly listed company in the US that employs roughly 200 individuals and manages around 2,000 separate accounts for institutions and high-net-worth individuals. It runs over 30 open-ended funds and 16 closed-ended funds, making it one of the largest closed-ended players in the US, with c. $7.5bn AUM. Outside of the US, it has offices in London, Tokyo and Shanghai.

The dedicated merger arbitrage portfolio team has seven professionals dedicated to identifying attractive merger arbitrage opportunities. They also benefit further from the deeper sector analyst pool employed at GAMCO. The team comb the globe for businesses whose financial and industry positions would be attractive for strategic buyers. This means that their research on numerous merger situations has been substantially done before any offer is made, making them able to act quickly and take up a position.

## Discount

GMP trades on a discount of c. 22.4% (as at 28/10/2020). This is wide by comparison to the average level since launch of c. 9%. However, as can be seen in the graph below, having initially traded at a premium after launch, the trust moved to a discount in summer 2018. As discussed under Performance, the difficulties of market makers in matching sell and buy orders in a thinly traded stock seem a likely culprit for further widening pressure this year. This can be seen in the extreme fluctuations in Q1 2020, against a backdrop of sharp market volatility. This type of behaviour was typical of many investment trusts in this period, irrespective of NAV performance. In GMP's case, the NAV held up well in the downturn, but the absence of buyers for almost any asset in the market sell-off proved challenging for market makers to match even small sell orders.

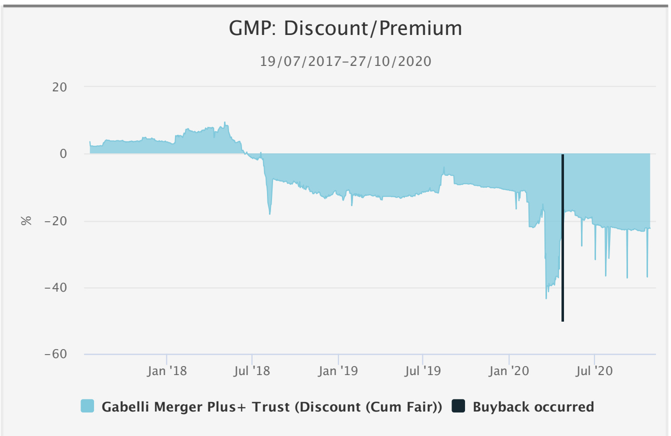
Associated Capital Group, an affiliate of GAMCO, holds c. 60% of all shares outstanding. Accordingly, trading volumes are relatively thin and this, along with the relatively small size of the trust, may be deterring investors who may perhaps otherwise regard this level of discount as a potential opportunity given the relative stability of the underlying NAV.

GMP's board has authority to repurchase up to 14.99% of shares in issuance, subject to renewal at the forthcoming AGM. Having previously declined to use this authority, on 6 April 2020 the board commenced a buyback programme with the intention of repurchasing up to 20,000 shares up to a maximum value of $200,000. It is perhaps emblematic of the difficulty trading significant volumes of GMP shares that, by the time the programme ceased in May 2020 (as a result of the trust's broker's decision to withdraw from the UK investment trust market), the board had only succeeded in repurchasing 5,960 shares at a discount of c. 16.2%. We have highlighted in the graph below the days on which buybacks occurred.

As such, whilst the discount is wide it may not represent an obvious opportunity for shareholders to benefit from discount narrowing. However, investors at admission (only those who have held since launch) will have the option to exit at NAV minus costs in 2022, when a continuation vote will also be held. Those who choose to remain will receive double the voting rights per share during the subsequent five years, and new shareholders can choose to subscribe to the trust's loyalty register to receive extra votes.

Whilst it may be challenging to see an easy route to value realisation from the discount opportunity, the sizeable narrowing seen by the board on very limited transactions should offer some reassurance that the board has the capacity and willingness to act to ensure the risk of further extreme widening is inhibited.

### Fig.4: Discount/Premium




Source: Morningstar, London Stock Exchange

## Charges

GMP presently has ongoing charges of c. 1.74%, compared to a peer group average of c. 2.65% (Source: The AIC). This includes a management fee of 0.85% p.a. and a performance fee of 20% of annual NAV absolute returns, subject to a high-water mark and hurdle rate. The performance fee is capped at 3% of the average NAV. The high-water mark is the closing NAV per share from the last performance period on which a performance fee was paid, whilst the hurdle rate focusses on achieving at least double the rate of return of 13-week Treasury Bills over the performance period.

GMP has a KID RIY of c. 1.39%, though this does not account for the performance fee subsequently paid since this figure was last published.

## ESG

GMP by design operates as a short-term shareholder of the underlying securities. The managers monitor for potential ESG-related risks that may reduce the likelihood of deals being completed, but ESG is not an integral part of the investment management process or portfolio construction.

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