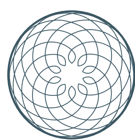

Kepler | Trust Intelligence

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Gabelli Merger Plus+ Trust

Update
02 October 2019

Summary

Gabelli Merger Plus+ (GMP/GMPP) aims to provide uncorrelated absolute returns by investing in announced mergers 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, it is seeking to benefit from share price uplift offered by the risk premium attached to announced deals; as such, returns will not be driven by wider equity market moves. The company aims to pay a 5% dividend yield on NAV, paid out of the cash received when deals close.

Although this trust was launched in July 2017, Gabelli has managed funds with this approach since 1985; in this period, it has generated annualised returns of 10.5% (gross of fees) with low correlation to equity markets.

While the trust's NAV total returns have been solid since launch, with returns of c.15.6%, share price returns have lagged as a moderate discount has opened; this now stands at c. -9%.

Dividends have been in line with the proposed payout of 5% since launch on the starting NAV. However, with the trust moving to a discount the annualised yield of the current latest payout is an attractive 5.3%

A sterling quote for the shares has recently been launched and trades under the symbol 'GMPP'; this is aimed at improving trading volumes and liquidity, and to broaden the shareholder register in the UK.

Kepler View

This is an idiosyncratic and highly differentiated offering relative to most products in the broader market. The managers have exhibited a successful longer-term track record in an investment strategy which itself has historically demonstrated strong absolute returns with low correlation to equity markets. However, it should be noted that historic returns benefitted from higher interest rate environments, which raises the spreads available on announced deals.

With interest rates globally at historic lows, absolute return levels in merger-arbitrage strategies have moderated. However, this product should continue to offer uncorrelated returns and low volatility across market cycles.

Kepler View

BULL	BEAR
Low to no correlation to wider equity market returns	The low interest rate environment continues to offer a headwind to absolute return levels
Should offer a good hedge against a rising interest rate environment	Whilst the sterling quote could help improve liquidity, trading volume remains an issue
An attractive level of dividend, at a 5.3% yield	

Key Information:

As at	30/09/19
Price (p)	718
Discount (%)	-9.04
OCF (%)	1.26
Yield (%)	5.4
Gearing (%)	0
Ticker	GMP / GMPP
Turnover Ratio (%)	247.47
Shares (£)	10,334,166
Market cap (£)	74,216,740

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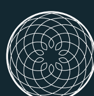

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Portfolio

Gabelli Merger Plus+ (GMP/ GMPP) seeks to provide investors with both capital appreciation and income through investing in companies subject to accepted merger / acquisition bids. The trust utilises a form of investing known as 'merger-arbitrage', profiting from a spread between an agreed acquisition/merger price and the price of the relevant company after the deal's announcement. Whilst an accepted bid ordinarily raises the price of the target company to near that of the offer price, there usually remains a residual 'spread' to be accessed as investors remain wary of potential risks to the deal being finalised.

As well as capital appreciation the trust targets generating a yield of 5% p.a. (paid quarterly) of the average quarterly NAV.

The general target rate of returns for deal spreads is c. 3-400bps in excess of a three-month US t-bill; presently this equates to c. 4.9-5.9% (1.9% plus the premium). However, the spreads available within this kind of strategy can vary widely, with greater returns potentially available for higher risk transactions.

As offers historically close at a premium to purchase price for the shares in the portfolio, risks to this strategy are particular to each deal and not generally related to wider market direction. Instead, they arise from potential obstacles to the deal being completed, such as regulatory/ anti-trust approval or rejection from a shareholder vote.

Typically, eligible deals for inclusion in this kind of strategy are friendly takeover bids, and can either be all cash, all stock, or a mix of stock and cash. In an all-cash deal, the manager takes 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.

If the bid from the acquirer involves stock as a source of funding for the deal, either wholly or partially, the manager will take a long position in the target company's shares, whilst shorting the stock of the acquiring company. This will be undertaken in proportion to the share exchange ratio offered in the proposed deal, and thus the spread is 'locked in'.

GMP/GMPP typically, but not wholly, focuses on friendly takeover bids, with a historic preference for cash bids. Investing globally, with a wide universe of ongoing M&A transactions in public markets, the manager seeks to identify and invest in those deals which they believe have the best risk/reward attributes, with a focus on ensuring they identify deals likely to succeed. This in part explains the preference for friendly takeover bids to hostile; friendly bids have been estimated to have a historic success rate of 82%, against 38% for hostile bids.

The investment process is initiated with idea generation, observing corporate announcements around M&A activity as they arise and feeding this into their proprietary 'Private Market Value with a CatalystTM' research methodology. Particular focus in evaluating the merger opportunity is paid to understanding all potential downside risks; for this reason, the team focuses on deals announced in jurisdictions with strong legal processes and governance, amongst other factors. The opportunity set is - in theory - global, although the team restricts itself to markets with high standards of governance as regulatory transparency and reliability is a key factor determining their ability to judge the risks of a given trade.

Analysing the regulatory, company-specific, financing, shareholder vote, and other risks helps determine the likelihood that a deal will indeed come to completion. The manager also makes an assessment of the likely timeline to realisation of returns. Position size is gradually built, with a relatively small position at initiation which the managers incrementally increase as the deal nears completion and the risks associated diminish.

Rather than wider equity market directionality, absolute returns within this kind of strategy tend to correlate more to the interest rate environment. The spreads offered on the merger-arbitrage trade typically follow the wider interest rate environment, as investors attach a greater/ lower risk premium if interest rates are rising/falling respectively. Simultaneously, changes in the risk-free rate, which deals are priced off of, also affect the level of return available within this strategy. This is not, however, a dependent relationship for absolute levels of return, but instead an indicative one.

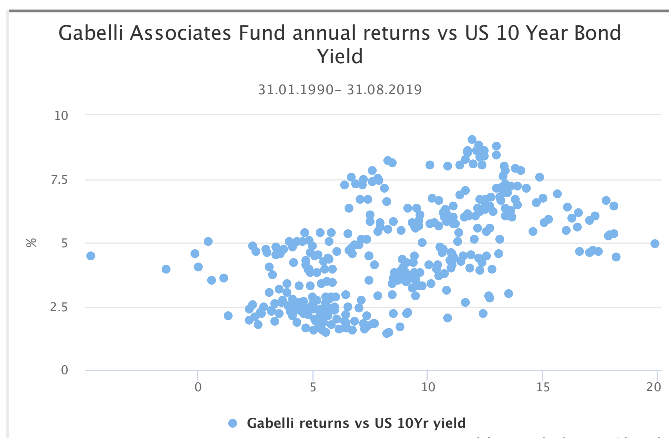
This can be seen in the graph below, which shows the subsequent annual returns of the long-running Gabelli Associates merger-arbitrage fund against the yield on a generic US 10-year government bond. When data points are further to the right on the horizontal axis, this indicates a greater level of return was subsequently achieved by the Gabelli strategy than data points further to the left. When they are higher on the vertical axis, this indicates the starting 10-year bond yield was at a higher level.

It shows that higher bond yields tend to be correlated with higher subsequent returns from the Gabelli strategy, but also that the return profile can vary around this somewhat as the wider market and macro environment encourages/ discourages corporate activity at different points in the cycle.

Whilst the strategy itself has seven dedicated team members, the team are also able to lean on and benefit from the insight of the broader analyst team at Gabelli. Although they are operating in a broad and deep investment universe, they are seeking to identify only the

most favourable deals from a risk/reward perspective, leaning on analytical insight from the deep investment team to build a portfolio where reasonably high conviction positions in deals nearing completion can materially drive portfolio performance. As trades in merger-arbitrage often exhibit asymmetric downside in the event that a deal fails to complete, Gabelli places a strong emphasis on ensuring the 'break-rate' is kept to a minimum.

Fig.1: Gabelli Associates Merger Arbitrage Fund Returns Against Us Ten Year Government Bond Yield



Source: Gabelli, Bloomberg

This has manifested itself in a low number of deal breaks; thus far in 2019, the trust has had no significant deal breaks.

Whilst the managers tend to use the stocks themselves to implement positions, they will also use contracts for difference on occasion. These tend to be in non-US deals, where these instruments offer greater liquidity and ease of trading. CfDs also allow them to more easily leverage their exposure to certain deals, and eases currency hedging within the portfolio.

Current portfolio and positioning

The managers of GMP/ GMPP remain of the belief that we are undergoing a 'Fifth Wave of Deal Activity', providing a structural boost to merger-arbitrage strategies. This posits that, with global capital markets more open than in the past, and company balance sheets strong and displaying plentiful cash, more activity is likely in the future as global companies seek to become more competitive in localised markets through acquisition. Lower levels of growth further incentivise companies to acquire market share to expand revenues. Current trade tensions between the US and China clearly offer some political risk to increased global corporate activity, but they believe this is outweighed by the structural environment across the globe.

Historically, the broader Gabelli strategy has typically invested between 60-80% of assets in the US, but within this trust (GMP/ GMPP) this level has generally been higher since launch in 2017 as a result of the global environment in this period. Presently c. 81% of assets are invested in the US. This remains a result of the available opportunity set, with greater growth in M&A activity in the USA; US activity has risen by c. 19% year on year so far in 2019, whilst European activity is down by around 50%. Similarly, US bond yields continue to offer a significant premium to European bonds, with attendant higher spreads attached to US deals; at the market level, US opportunities offer on average between 5-6% spreads compared to 3-4% in Europe.

The trust's largest position is in Celgene, which has accepted a bid from Bristol-Myers Squibb. Celgene operates within this biopharmaceutical sector; presently, their business is dominated by a single product with a patent due to expire in 2024. However, the managers judged Celgene to offer strategic value to Bristol-Myers due to the strong pipeline of products. The deal was opposed at the shareholder vote by a particular activist investor in Bristol-Myers, but this was unsuccessful and shareholder approval was confirmed. Some anti-trust risk remains, but Gabelli expects this deal to close within the coming months. In addition to the cash + stock offer from Bristol Myers, there is a further Contingent Value Right of $9 per share attached to this deal subject to FDA approval of drugs in Celgene's pipeline; the managers view this as offering additional optionality to the deal, noting that these are either worth $0 or $9. They are, however, reasonably optimistic that this value will also be realised.

Whilst GMP/ GMPP has a preference for friendly bids due to their greater likelihood of completion, the team are willing to hold hostile bids. Presently they have one such position, in Circor which was subject to a cash bid from Crane. The revised offer of $48 a share was a substantial uplift to the market value at the time of offering (present value of Circor shares are c. $37 as of 11/09/2019), but was rejected. However, Gabelli covers both of these companies within the broader equity strategies and is a large shareholder in both. Therefore, whilst they are seeking to control risk by keeping the position size relatively small at c. 0.5% NAV, they are retaining this position.

Gearing

The strategy deploys leverage, which means that overall the trust has a gross exposure of greater than 100%; as of 31.08.2019 the gross exposure was 112.6%, which is substantially lower than the 250% permitted in the prospectus. However, as some positions involve holding short exposure to stocks, the net exposure of the portfolio is 84.6%.

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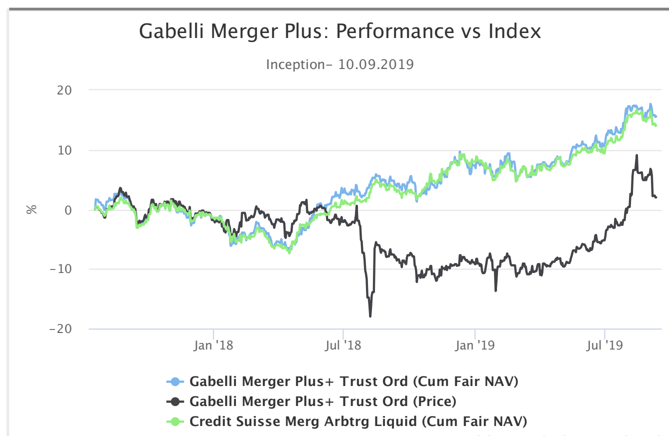
The company currently has no structural debt; it does, however, on occasion uses contracts for difference in the place of cash equities to build positions. These are cheaper and more liquid than the shares and can be used to gear up the trust as they allow the exposure to the underlying asset to be higher than the amount of cash held as collateral.

Returns

The trust itself, GMP/ GMPP, has a relatively short-term track record, having only been launched in July 2017. Over this time the trust has produced NAV returns in excess of a wider Credit Suisse merger-arbitrage index (15.6% vs 14.1%), though share price returns (2%) have lagged as a result of a widening discount.

Fig.2: Since Inception



Source: Morningstar

In the table below we can see the median rolling R2 over the past 10 years in sterling terms of the Credit Suisse index to large-cap US equities, to global equities, and to a broader index of investment trusts operating hedge fund strategies (the peer group for this trust). The higher the number, the greater the correlation of returns on average. What the low values seen here would suggest is that generally these strategies are providing idiosyncratic returns relative to the equity markets in which it is nominally investing.

R2 To Us Indices

	TO US LARGE CAP	TO GLOBAL STOCKS	TO MORNINGSTAR IT HEDGE FUNDS
Credit Suisse Index Average R2	0.13	0.12	0.44

Source: Morningstar

Positive performance contribution for the GMP/ GMPP trust in recent months has come from several sources, with the greatest performance contributor being a now-closed position in Red Hat. Red Hat was subject to a bid by IBM, which felt it offered strategic benefits to IBM in its attempts to develop the cloud technology business. Gabelli assessed there to be no balance sheet risk from IBM, and with no shareholder vote necessary this too posed no risk to the deal. Accordingly, the only significant risk was perceived to be regulatory from anti-trust authorities; however, the managers deemed this to be minimal. Throughout the deal spreads were typically at between 5-10%, and the managers deemed this to be sufficiently attractive to build a sizeable position ultimately totalling around 6% at cost. This deal was ultimately approved.

On the negative side, the position in Spark Therapeutics has been challenging. Spark is a pharmaceutical company which develops gene therapy for patients with debilitating genetic diseases. After inviting bids they were targeted for acquisition by Roche, which ultimately proved successful with a bid of $114.50 a share in cash. With Roche as the acquirer there was little to no financial risk to the deal. However, this position ran into concerns over regulatory difficulties; Roche manufactures the market-leading drug for haemophilia, the condition that Spark was seeking to remedy with its gene therapy product. Roche's patent has significant time to expiry in excess of 10 years, and increasingly there are concerns that the transaction will be disallowed on anti-trust grounds, with the FTC facing political pressure over drug pricing. Gabelli does not believe this concern to be warranted, noting that there is significant competition within gene therapy targeting haemophilia, and that there is not even proof yet that it will prove successful as a remedy. As of 12/09/2019, this deal offers a spread of around 9%, and Gabelli has retained exposure on the expectation that the deal will close in the first half of 2020.

If we were to see higher interest rates in the future, and were the concomitant tighter money supply that would accompany this to negatively affect equity markets, the strategy should remain relatively unaffected by equity markets whilst benefiting from higher interest rates. This low level of reliance on rising equity markets for positive returns can be seen looking at the long-term track record of the Gabelli Associates Fund operating the same strategy.

Looking at monthly returns from the strategy and from the MSCI World since 1990, we can see:

- The Gabelli strategy recorded 54 negative months from 355 total (15%)
- By comparison, the MSCI World Index was negative on 134 occasions (38%)

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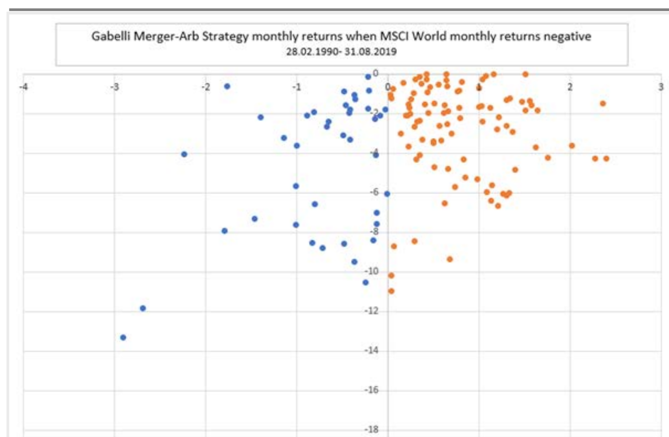
- The Gabelli Fund was negative on 41 occasions when the MSCI World was also negative (31%)
- On average, the Gabelli fund made a monthly return of 0.31% in months when the MSCI World was negative; this equates to an annualised return of c. 3.8%
- In those same months, the MSCI World on average feel by -3.5%; this equates to an anuualised rate of c. -35%.

This can be seen in the chart below, which shows returns from the Gabelli Associates Fund (x-axis) against those from the MSCI World (y-axis) in months when the MSCI World was negative. Where returns are to the right of 0% on the horizontal access, and where the data point is coloured orange, the Gabelli returns were positive. Those to the left of 0%, and coloured blue, were negative.

Fig.3: Gmp Monthly Returns When Market Negative



Source: Gabelli, Morningstar

Dividend

At launch the company committed to pay out 5% of the average NAV over each quarter in a dividend. Distributions in the first year were 47 cents, amounting to roughly 4.7% of the NAV at launch. The first three dividends of the 2019 financial year have each been 12 cents, which would annualise to 4.9% on the current NAV. Annualised, the dividend yield would be 5.3% on the current share price.

Management

Gabelli Merger Plus+ is managed by Gabelli Funds, LLC. Based in Rye, New York, the Gabelli organisation collectively oversees $41 billion in assets, as of March 2019. Mario and Marc Gabelli lead the fund's portfolio team, overseeing the implementation of the "Private Market View 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.

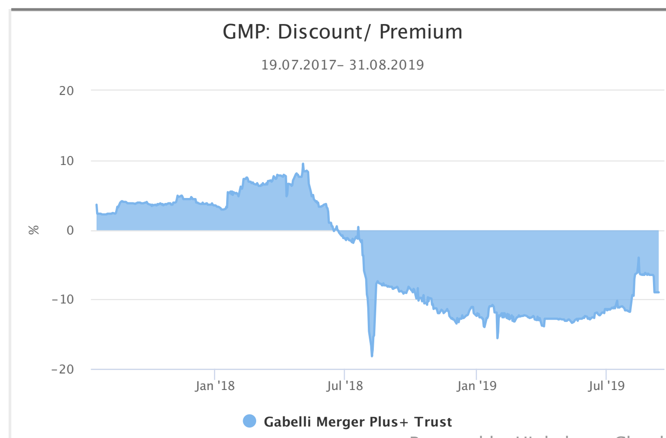
The dedicated merger arbitrage portfolio team has seven professionals dedicated to identifying attractive merger arbitrage opportunities. They also benefit further from the deeper analyst pool employed at Gabelli. The team combs the globe for businesses whose financial and industry positions would be 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

Presently the discount is c. 6.9%. The company's shares traded on a significant premium after launch, but this reversed in the summer of 2018. Following the decision by an institutional shareholder to sell down its position, the discount widened swiftly to 20% before reversing swiftly to around 7%. This extreme volatility was caused by thin August trading reducing price discovery and the relatively illiquid shares – 60% is owned by affiliates of Gabelli.

The discount has continued to narrow further in 2019. Whilst the board has the discretion to undertake buybacks, it has not done so since launch; investors at admission, however, will have the option to exit at NAV minus costs in 2022. Those that choose to remain will receive double the voting rights per share during the subsequent five years; new shareholders can choose to subscribe to the company's loyalty register to receive extra votes.

Fig.4: Discount



Source: Morningstar

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Charges

The ongoing charges are 1.48%. This includes a management fee of 0.85%. There is also a performance fee of 20% of absolute NAV total returns, subject to a high watermark and a hurdle rate, calculated annually.

ESG

Find out how the trust targets a 5% yield from merger-arbitrage

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