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DRIEHAUS EVENT DRIVEN STRATEGY

TWTR Closed??!! What Were the Odds?

Imagine placing a bet on a sporting event for which one casino offers winning payout odds of 3-to-1 and a different casino offers odds of 6-to-1...for the same bet. Who wouldn't choose the latter? Using multiple securities — as opposed to using strictly equity — to invest in merger arbitrage presents a similar opportunity to increase the odds of a successful investment. The strategy's investments in Twitter illustrate this compelling value proposition of using multiple securities to invest in merger arbitrage.

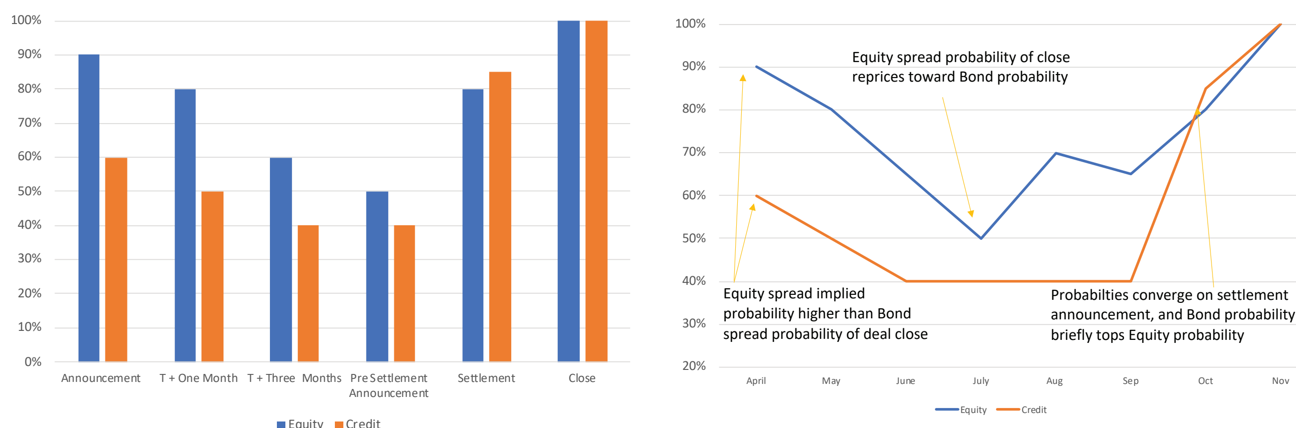
After nearly six months of "will he / won't he" M&A drama, Elon Musk finally completed his acquisition of Twitter (TWTR) on October 27th. Between the multiple twists and a cast of colorful characters, the deal process had all the makings of a Hollywood thriller (or satire), but ultimately, the strength of contract law and the US judicial system brought the deal to a close.

Although the path of this deal was unique, it provided an affirmation of our investment philosophy: employing a multi-asset approach to merger arbitrage can produce better risk-adjusted returns than the traditional equity-only framework.

While traditional arbitrage investors rely strictly on common stock, and bear the associated downside and volatility, the strategy structured its investment to capture profit — both long and short — within Twitter's equity and bonds. This differentiated exposure produced an attractive absolute return, while minimizing risk of loss and volatility.

The charts below compare the TWTR equity arbitrage spread to that of the bonds. One can see that utilizing the bonds created the arbitrage spreads at a lower implied probability of deal close (Exhibit 1).

Exhibit 1: Implied Probability of Deal Close



Source: Driehaus

Using bonds and a short equity position to structure the TWTR merger arbitrage had the added benefits of reducing volatility and providing downside protection in the potential outcome of a deal break, relative to the equity-only spread. With the 'overpriced' odds for the equity and the 'underpriced' odds of the credit, investors could short some equity on a ratio against the bonds to protect downside. This became increasingly appealing as the standalone break price deteriorated during the deal timeline, due to weakening fundamentals in the industry.

The table below provides an overview of our structuring of the TWTR merger arbitrage position at various milestones in the deal process.

Exhibit 2: Driehaus Event Driven Strategy Structuring of The TWTR Merger

Event	Structure / Action Taken	Rationale	Implied Probabilities of Deal Closure	Ultimate Internal Rate of Return (IRR)
Deal Announcement	Long Bonds / Short Equity on Ratio	Bonds underpriced probability of deal closure relative to Equity arbitrage spread	Bonds: 50% / Equity: 80%	20%+
Deal Placed 'On Hold'	Added Long Convertible Bonds	Convertible Bonds implied lower probability of deal closure with stronger downside protection, relative to Equity spread	Bonds: 50% / Equity: 60%	25%+
Deal Terminated	Covered Portion of Short Equity	Equity repriced deal odds closer to Bonds	Bonds: 40% / Equity: 50%	25%+
Settlement Announced	Sold Portion of Bonds	Bond odds converged toward Equity probabilities	Bonds: 80% / Equity: 80%	10%+
Lead Up to Deal Closure	Added Long Equity	Equity probability underpriced relative to Bond arbitrage spread	Bonds: 90% / Equity: 85%	30%+

Source: Bloomberg

The ability to stay flexible and utilize multiple securities across asset classes over the lifetime of the deal insulated the strategy from short term volatility and reduced tail risk, all while allowing the strategy to achieve an attractive risk-adjusted rate-of-return in the merger spread.

While the drama of the Twitter deal presents an interesting case study, our approach to this deal was similar and steadfast to how we always approach merger arbitrage: utilizing multiple asset classes to generate the most favorable odds for investment success.

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