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MARKET REVIEW AND OUTLOOK

WESTCHESTER CAPITAL MANAGEMENT
A VIRTUS INVESTMENT PARTNER

MARKET REVIEW

Overall, 2023 presented a mixed picture for the mergers & acquisitions ("M&A") market, especially considering the challenges faced in the previous year. Given the difficult conditions in 2022, it was no surprise that merger activity remained subdued. Factors such as rising rates, increased financing costs (particularly concerning private equity), ongoing geopolitical tensions, and a narrowly escaped banking crisis in the first quarter contributed to company boards adopting a more cautious approach toward corporate reorganizations, particularly in the first half of the year.

However, as the year progressed, there was a noticeable improvement in CEO confidence. This positive shift can be attributed to a better understanding of the regulatory environment. Notably, several high-profile transactions, including Horizon/Amgen, Activision/Microsoft, and VMware/Broadcom, received clearance, boosting confidence in the market. This positive development paved the way for a solid second half of the year, with merger and acquisition volume reaching over $1.7 trillion, out of the total global value of $3.1 trillion for the entirety of 2023.

Diving deeper into overall activity, there are several noteworthy attributes both domestically and internationally. North America continued to be a driving force in merger activity, reaching a new record of 58% of the total global volume in 2023. This rebound was primarily propelled by strategic transactions, with deals over $20 billion accounting for a record 28% of the total volume alone in the region, as reported by Dealogic.

Internationally, cross-border transactions accounted for 28% of overall volume, surpassing the average of 25% for the past four years. This increase in cross-border activity can be attributed to the recently improved regulatory predictability. A notable reflection of this is that deals valued at $10 billion contributed to 21% of cross-border volume, a significant jump from 12% in the previous year.

The uptick in cross-border activity indicates that many of the previous uncertainties and obstacles that hindered such combinations are gradually being overcome. It also signifies a growing confidence among companies that they can navigate the regulatory complexities and secure the necessary approvals to move forward with these transactions. This is encouraging, as it demonstrates a willingness to invest in strategic partnerships on a global scale, highlighting that companies are more inclined to seize opportunities for growth and market access in foreign markets.

SPECIAL SITUATIONS

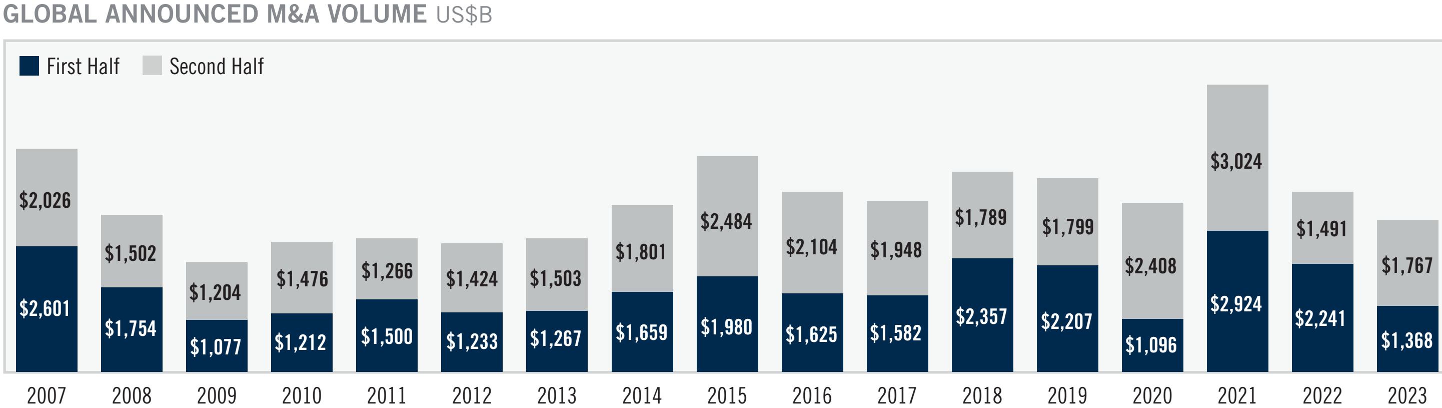
In addition to mergers, the rate of corporate transactions, such as spin-offs and divestitures, has risen since 2020. A focus on operational optimization, efficiency, and balance sheet management fueled these restructuring activities. These types of corporate separations offer several advantages, the most notable being the increased merger and acquisition opportunities for investors that often follow. When a business unit is separated from the larger corporate entity, it becomes an independent entity capable of structuring its own deals. This newfound independence and specialization also make the separated entity a potentially attractive merger target. As a result, the increase in corporate sales and divestitures over the past three years has led to a surge in M&A transactions. In 2023, corporate separations accounted for approximately 33% of merger activity in the U.S. alone. This represents the highest share in almost a decade and further reflects increased corporate confidence.

CORPORATE SEPARATIONS

Cross-Border	As % of U.S. M&A Volume
2020	22%
2021	25%
2022	23%
2023	33%

As of 12/31/23. Source: Dealogic, Deal Point, and FactSet.

GLOBAL ANNOUNCED M&A VOLUME US$B

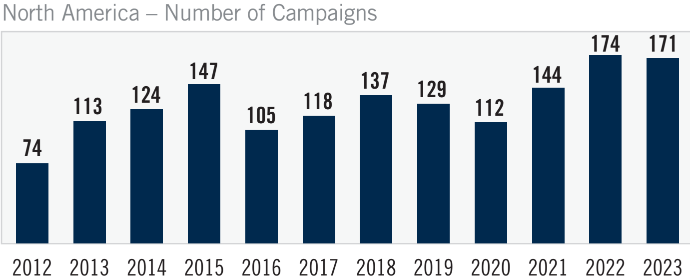


As of 12/31/23. Source: Citi, Dealogic, and assumed to reliable.

Additionally, activist investors have increased their profile significantly. In addition to agitating for corporate separations as a way to unlock value, activism has played a substantial role in going private transactions, also known as management buyouts or leveraged buyouts. These transactions occur when a company's management team, along with external investors or a consortium, often in combination with a private equity firm(s), acquire all the outstanding shares of the company's stock, transitioning the company from publicly traded to privately owned. By partnering with management teams and external investors, they facilitate the transition to private ownership, allowing companies to operate with greater flexibility and focus on long-term strategic goals. Activists' involvement in take-private transactions highlights their influence in shaping the M&A landscape.

ANNUAL ACTIVIST CAMPAIGN ACTIVITY

North America – Number of Campaigns



As of 12/31/23. Source: Citi, FactSet.

FINANCIAL SPONSORS

In our discussions with our network of bankers and attorneys, the increase in interest rates and stricter lending conditions made it more difficult for private equity sponsors to transact in 2023. This was evident from the ~36% year-over-year decrease in the dollar volume of private equity transactions, which was the lowest since 2013. However, this doesn't mean sponsor activity came to a halt. In fact, financial sponsors-led acquisitions from corporate sellers accounted for ~55% of the total number of sponsor-led deals in 2023, the highest share since 2008, according to Citi. This was made possible by using creative financing structures, such as increasing upfront equity during the initial purchase with a plan to utilize leverage in the future when debt market conditions improve. Additionally, sponsors collaborated with other sponsors through the formation of consortiums to gather the necessary equity to initiate a deal. Furthermore, we saw private credit funds emerge as a significant source of funding in 2023. Not only were they able to finance larger deals, but they also provided more flexible financing solutions. From our perspective, it is likely that these trends will continue to be seen in 2024.

TOP M&A DEALS OF 2023

The busiest sectors included energy—led by Exxon Mobil's acquisition of Pioneer Natural Resources and Chevron's acquisition of Hess—and healthcare, which was led by Pfizer's purchase of the cancer drug maker Seagen.

A KEY ISSUE IN 2023

Another relevant consideration companies faced in 2023 was the challenge of agreeing on transaction terms amidst recent macroeconomic and political turmoil. Aggressive rate tightening since 2022 by the Federal Reserve made debt financing more expensive, ultimately reducing the projected enterprise value of acquisition targets. Moreover, rising rates make it difficult for buyers to accurately plan transaction costs, adding more complexity. These challenges, combined with the uncertain political outlook and recession potential, hindered timing and negotiations. For those that moved forward, the bid-ask spread was significant.

Sellers experienced a stock market that pushed equity prices to record highs. As a result, target companies often pushed back against offers that they believed did not reflect their intrinsic

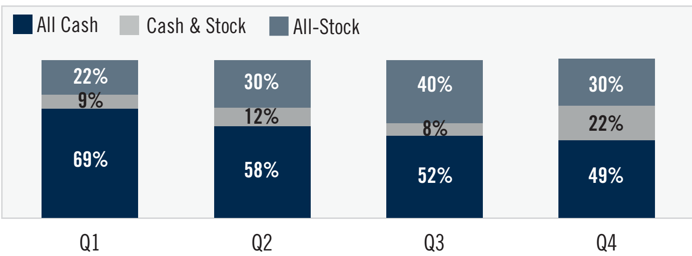
Ann. Date	Target Name	Acquirer Name	Acquirer Country	Value ($ mm)	Deal Consideration	Target Sector	Strategic
10/11/23	Pioneer Natural Resources	Exxon Mobil Corp.	US	59,522	Stock	Energy	Y
10/23/23	Hess Corp.	Chevron Corp.	US	53,003	Stock	Energy	Y
3/13/23	Seagen Inc.	Pfizer Inc.	US	44,469	Cash	Health Care	Y
9/21/23	Splunk Inc.	Cisco Systems Inc.	US	28,243	Cash	Info. Technology	Y
12/18/23	United States Steel Corp.	Nippon Steel Corp.	JN	14,127	Cash	Materials	Y
12/22/23	Karuna Therapeutics Inc.	Bristol-Myers Squibb Co.	US	13,957	Cash	Health Care	Y
5/15/23	Magellan Midstream Partners	Oneok Inc.	US	13,817	Cash and Stock	Energy	Y
4/3/23	Life Storage Inc.	Extra Space Storage Inc.	US	12,428	Stock	Real Estate	Y
3/13/23	Qualtrics International	Silver Lake, Cppib		12,006	Cash	Info. Technology	N
9/12/23	Westrock Co.	Smurfit Kappa Group Plc	ID	11,780	Cash and Stock	Materials	Y

As of 12/31/23. Source: UBS.

continued

value. The significant disparity then made negotiations challenging. In our opinion, this, in turn, led to a more cautious "wait-and-see" approach, and, in some cases, public companies looking to dispose of business units often turned to corporate separations as an attractive way to unlock value while avoiding the risk of selling "low" and missing out on the value accretion that may be available to shareholders in the future.

NORTH AMERICAN M&A DEAL CONSIDERATION 2023
% of Number $200M+ Deals



As of 12/31/23. Source: Citi, Dealogic.

Stabilization and predictability have already begun alleviating these tensions. The expected shift in monetary policy will make it even easier for buyers to anticipate the financial implications of a transaction, even if financing remains somewhat elevated from prior levels. Creative deal structures, including all-stock purchases or a mix of stock and cash, could also bridge the value gap in otherwise highly synergistic combinations, a trend we have already begun seeing.

Regardless, pressures are intensifying on sellers to obtain liquidity and buyers to realize growth and innovation through acquisitions—often just to keep up with global technology, energy transformation, and sustainability. Dampening inflation and a potential "soft landing" should encourage dealmakers to come off the sidelines in 2024. This would be welcome news to investment bankers who have continued to report that acquisition dialogues remain robust.

SPREADS

By the end of December, the median spread of definitive mergers in our global deal universe increased by three basis points quarter-over-quarter to an annualized rate of 12.9%. We believe this can be attributed to the successful closure of several older deals that were structured in the prior lower-rate environment, which were replaced by new transactions that offered higher rates of return commensurate with the increase in rates from prior years. Additionally, the second half of the year saw an increase in "mega-cap" deals, which often face regulatory scrutiny and longer timelines for approval.

Although dealmakers have grown more confident in their ability to get highly scrutinized deals over the finish line, the assumed risks associated with these trades, particularly in light of the current regulatory environment, tend to result in wide risk premiums (trading spreads). Given our expertise and resources, these situations often present compelling opportunities for us to evaluate the factors influencing a deal's potential success or failure. In many cases, through our research and investment process, we are able to identify attractive situations that appear mispriced, providing us with attractive entry points to initiate trades that have the potential to earn high-risk-adjusted returns.

THEMES AND OUTLOOK

Looking ahead to 2024, we are optimistic about a continued increase in corporate activity. Uncertainty is among the biggest challenges to M&A, but with more regulatory clarity, thanks to a positive track record of wins in the courtroom, we expect the positive momentum of deal activity to continue. Furthermore, both acquirers and sellers have adapted their processes. Buyers, in conjunction with their deal teams, have now begun focusing on transaction feasibility much earlier in the process in anticipation of increased scrutiny by regulators (as opposed to after an agreement), identifying potential challenges and developing responses ahead of time as a way to preempt delays in deal completion. Sellers have contractually obligated more safeguards, such as drop-dead dates, more stringent effort standards[1], and reverse termination fees to ensure alignment between the parties. This has been true, particularly among companies that are market leaders in their respective sectors and in cross-border deals involving more sensitive industries.

Furthermore, as the economic outlook stabilizes, the mismatch in price expectations between buyers and sellers is likely to narrow, especially as interest rates begin to come down. In fact, non-financial companies in the S&P 500® Index currently hold over $1.8 trillion in cash, providing ample buyer power for those looking to capitalize on strategic acquisitions.

On the private equity side, sponsors are facing increasing pressure to monetize their assets, as they currently have a total of $1.5 trillion in dry powder in North America alone. Moreover, the catalysts for activism continue to persist, with many campaigns pushing for M&A transactions to unlock shareholder value.

With a predictable cost of capital and ongoing pressure to look for opportunities to keep up with innovation across all industry groups, we anticipate an increase in corporate activity in 2024, a trend we have already begun to see in the first few weeks of the new year.

continued

[1]A contractual provision that outlines the level of effort and actions that the parties involved will undertake to complete the transaction. Recently, sellers have been strengthening these standards by including language that if the deal is subject to court proceedings by regulators, the acquirer will dedicate the resources needed to defend the case in an effort to ensure the successful completion of the transaction.

Authored by:

The Westchester Capital Management Team

For over 30 years, Westchester Capital Management has endeavored to deliver consistent, absolute returns through the disciplined execution of event-driven alternative investment strategies.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Bloomberg U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The indexes are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.