EDISON

ABC arbitrage

Initiation of coverage

A specialist arbitrage trader and asset manager

Financials

ABC arbitrage group (ABCA) has been successfully developing and executing non-directional trading strategies since 1995, which has allowed the group to deliver a strong ROE of 22% over the last 15 years (with an ROE above 10% in each of these years). Historically, ABCA has paid almost all its profits as dividends. As the group has opened some of its strategies to external investors, it also offers the prospects of growing fee income from third-party capital (6.5% of total revenue in 2022).

Year end	Revenue (€m)	EBITDA (€m)	EPS* (€)	DPS (€)	P/E (x)	Yield (%)
12/21	64.3	37.1	0.48	0.40	12.4	6.7
12/22	61.4	30.8	0.49	0.41	12.1	6.9
12/23e	42.5	17.1	0.25	0.30	23.3	5.0
12/24e	62.9	29.2	0.46	0.37	13.0	6.2

Note: *EPS is as reported by the group.

Diversification of trading strategies benefits returns

ABCA employs 30–40 highly automated, quantitative strategies developed in-house and invests considerable resources to maintain its edge in the market; most of its activity is based on models modified over the past five years. Key to the success of the business has been the development of a robust and proprietary IT infrastructure, enabling a fully integrated systematic trading workflow that operates on a 24-hour basis. We also note that its mean reversion strategy benefits from high volatility in the market and represents an effective hedge against the risk of market dislocation.

Targeting €800m in third-party AUM by 2025

ABCA managed c €185m of external third-party AUM as at end-2022 in two funds, ABCA Reversion Fund and ABCA Opportunities Fund, and individual managed accounts. Management believes that its strategies have the capacity to onboard up to €800m of third-party capital across its existing strategies (on top of €200m of its internal equity). A successful increase in third-party assets under management (AUM) would further drive ABCA's profits beyond its proprietary trading gains. We estimate that every €100m of AUM increase would add c 8% to its FY25e earnings per share.

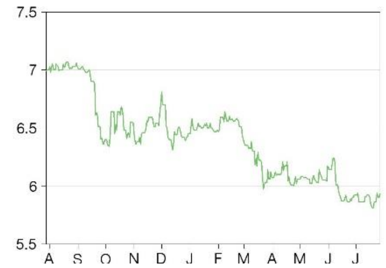
Valuation: Upside from growing AUM

In our base scenario, assuming growth in third-party AUM to c €434m and €617m by FY25e and FY27e, respectively, and ABCA's long-term return on equity (ROE) of c 16% pa, we arrive at a fair value per ABCA share of €6.84 (c 15% above the current share price). Our bear case scenario assumes no additional inflow of third-party capital and suggests a fair value per share of €5.76 (3% downside), whereas in our bull case scenario we assume ABCA reaches its target third-party AUM of €800m by 2025, which renders a fair value of €8.32 per share (40% upside).

28 July 2023

Price	**€5.93**
Market cap	**€353m**
	£0.858/€
Shares in issue	59.6m
Free float	51.9%
Code/ISIN	ABCA/FR0004040608
Primary exchange	Euronext Paris
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	0.5	(1.5)	(15.3)
Rel (local)	(3.0)	(1.5)	(27.9)
52-week high/low		€7.1	€5.8

Business description

ABC arbitrage is a quantitative trading and asset management business specialising in a range of market-neutral, arbitrage strategies (liquidity, statistical, risk and derivatives arbitrage). The company also manages third-party capital (c €185m at end-2022).

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Investment summary

Company description: Listed access to niche markets

ABCA is a quantitative trading and asset management business specialising in a range of market-neutral arbitrage strategies (liquidity, statistical, risk and derivatives arbitrage) to generate returns irrespective of the prevailing price trend. ABCA's listed shares offer investors access to uncorrelated strategies often not available to retail investors, as the minimum ticket size usually amounts to over €1m. The investors also gain access to its highly profitable niche strategies that operate in smaller pockets of the market and do not have capacity to accommodate third-party capital. On top of that, its listing comes with the benefits of regulatory oversight and transparency.

ABCA also manages third-party capital through the ABCA Reversion Fund and ABCA Opportunities Fund, generating steady fee income, which over the last 10 years has made up 5–20% of ABCA's total revenue. As part of its current strategic plan (called 'Springboard 2025'), ABCA aims to maintain a solid ROE (of at least 10%, with the ambition to deliver over 15%) and significantly grow its third-party AUM to c €800m to increase its fee income.

Financials: Double-digit ROE likely to be sustained

We expect ABCA to continue delivering a double-digit ROE in the coming years (except for 2023) of around 16%, assuming gross returns on its reversion and risk arbitrage strategies of 11% and 8%, respectively, and higher (double-digit) returns on its high-return niche and incubator strategies. Although the returns of ABCA Reversion Fund have recently been more muted (for reasons discussed later in the note), we believe that a higher interest rate environment coupled with a return to more normalised volatility (higher than the post-global financial crisis, pre-COVID-19 levels) should assist ABCA's core strategies.

While ABCA sees potential to absorb up to €800m of third-party capital, we note that it is yet to fully deliver on the envisaged AUM growth (its 2022 ambition assumed total AUM of €1bn by end-2022). Therefore, we conservatively assume external AUM at end-2025 of €434m generating c €10m in total annual revenues for ABCA. Based on the above ROE and AUM assumptions, we have valued ABCA using a discounted cash flow (DCF) approach, arriving at a fair value per share of €6.84 (assuming an 8.5% cost of capital).

Sensitivities: Market conditions and AUM growth

Key market factors determining ABCA's trading gains include volatility and trading volumes, as well as mergers and acquisitions (M&A) and corporate actions. The return from ABCA's risk arbitrage strategy is dependent on the level of global M&A volumes, which have recently been constrained by deteriorating debt funding conditions. While we expect M&A volumes to remain subdued until at least the final quarter of 2023 (with a pick-up conditional on improved macroeconomic visibility), they are likely to recover at some stage given their high cyclicality. We also note that the recent tightening of financial conditions by global central banks provides a backdrop of increased volatility, which is likely to benefit systematic strategies, even as M&A activity is for now somewhat muted.

We also note that, while ABCA's core activities by nature are hedged against directional equity market risk, unanticipated shifts in the market correlation structure can create short-term challenges, as seen in 2022 when the return on the ABCA Reversion Fund was below that implied by the prevailing level of S&P 500 volatility.

Finally, our earnings forecasts assume a certain level of growth in external third-party capital. We calculate that every €100m increase (or decline) in ABCA's FY25e AUM increases (or reduces) its earnings per share by c 7.7%. If we conservatively assume no new third-party AUM going forward, we would arrive at a fair value per ABCA share of €5.76. Assuming ABCA reaches its €800m target by FY25e, its fair value per share would be €8.32.

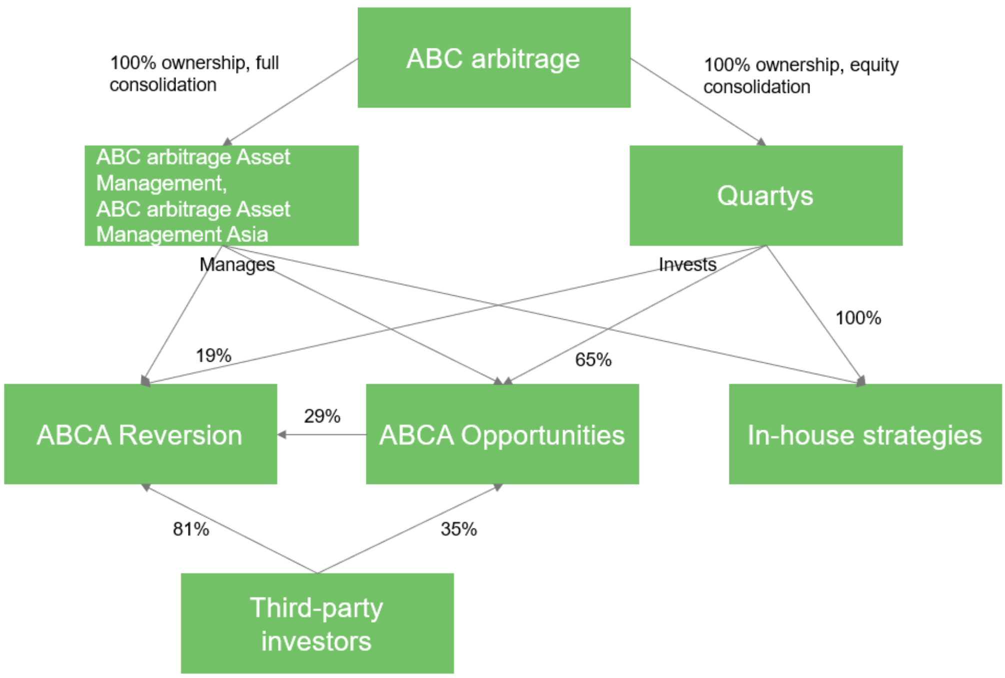
Company description: Experienced arbitrage investor

Successfully deploying its trading strategies since 1995

ABCA exists to exploit pricing discrepancies and anomalies in liquid global markets. It has successfully traded under the same management team since 1995 and became a public listed company in 1999. Initially, ABCA was listed on the Marché Libre market of Euronext Paris, and moved to the regulated market in 2003. At inception in 1995, the company was entirely focused on short-term trading opportunities involving an asset turnover several orders of magnitude higher than a traditional investment fund. This was and remains an inherently statistical and highly automated trading activity, demanding a culture of rigorous and disciplined technological development, which persists to the present day. The range of strategies has since broadened and now includes a quantitative approach to trading M&A on public markets. ABCA therefore has a long history of successfully identifying and exploiting market inefficiencies across a diversified range of systematic strategies.

The group currently employs 30–40 individual trading strategies with differing return profiles, offering significant diversification benefits. Currently, these strategies are primarily active in equities and equity derivatives (and to a limited extent also in commodities), although the group has previously also traded in foreign exchange and interest rate markets. A crypto-arbitrage based strategy has been extensively tested and management intends to provide the basis of a new fund launch once trading volumes and sentiment towards the asset class rebound.

Exhibit 1: ABC arbitrage organisational chart



Source: ABC arbitrage

External third-party assets under management

In the last decade, ABCA has opened some of its strategies to third-party investors through separately managed accounts and Irish-domiciled Qualifying Investor Funds (QIFs). Funds are created for those strategies that management has rigorously tested and implemented in-house but also have the inherent capacity to absorb more trading capital than the firm can employ on a proprietary basis.

At present, the firm believes it has capacity to offer an attractive home for up to €800m of external capital across its existing strategies, in addition to c €185m of external capital currently employed (of which €124m is in ABCA Reversion Fund; €21m in ABCA Opportunities Fund; and €40m in managed accounts). Priced weekly, the external funds provide useful additional transparency, which demonstrates the return-generating capabilities of ABCA's models.

This growth in external third-party AUM is supported by a distribution team that aims to build deep and long-term relationships with a relatively limited number of institutional investors, reflecting the niche qualities of ABCA's fund management proposition and the relatively large minimum investment size of €1m. Management is targeting investors in both Europe and the US, in the belief that more sophisticated investors are better able to understand the relatively technical nature of the investment processes.

ABCA Reversion Fund

The ABCA Reversion Fund had US$187m under management as at end-December 2022 and provides access to liquidity-driven, high-frequency trading models, which aim to exploit short-term price discrepancies in financial markets. The strategy is uncorrelated to broader equity markets, showing -16% correlation to the S&P 500 since inception. ABCA is the investment manager, providing exclusive access to its liquidity models, which are automated but always subject to close human supervision. The firm maintains a 24-hour dashboard on each active model to monitor profitability in real time and enable risk management. There is no concept of a 'star trader' or portfolio manager.

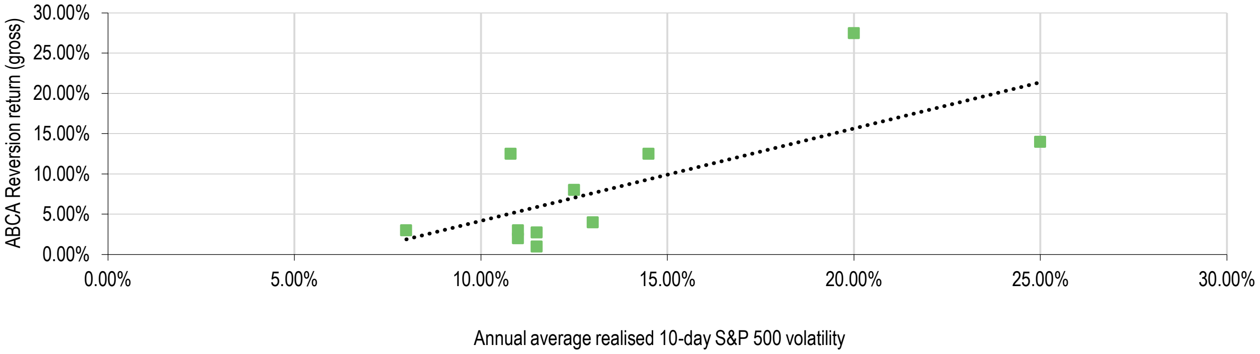
The average leverage of the ABCA Reversion Fund is 1.1x, defined as the sum of the fund's notional longs plus notional shorts, divided by AUM. Leverage typically peaks at a higher level in the middle of the European trading day when all global markets are active.

While systematic, if the trading models are subject to an unusual external factor in the markets such as an earthquake, there is management discretion to not trade and de-escalate. Company experience has shown that unusual events tend to lead to greater profits overall even if there are some early losses. The heightened volatility that follows such an event is typically a target-rich environment for achieving above-average returns.

Returns for the fund since 2010 have historically been strongly correlated to market volatility (see Exhibit 2) and we believe that this relationship should persist in future. Nevertheless, assuming a normalised level of volatility in coming years, we would expect the fund to return somewhat more than its historical average of 6.2%. This is because of significantly higher short-term interest rates compared to the previous decade. Approximately 80% of the fund's holdings are in cash as a collateral and receive a return based on money market rates.

The most recent performance of ABCA Reversion was somewhat subdued compared to a broader timeline, despite increased volatility amid monetary tightening. The markets experienced unusual spread widening between US and European markets in response to the Russian invasion of Ukraine, which affected the mean-reversion strategy. We believe the markets have adjusted to the 'new normal'.

Exhibit 2: ABCA Reversion* – an 'option' on increased volatility



Source: ABC arbitrage. Note: *Qualifying Investor Fund.

ABCA Opportunities Fund

The ABCA Opportunities Fund offers a systematic approach to investing in corporate transactions described by the company as 'Quant M&A' and had AUM of US$67m as at end-December 2022. This systemised risk arbitrage strategy has an average holding period per deal of around three months, significantly longer than those of the ABCA Reversion Fund. This strategy has low correlation to equity markets, with a 41% correlation to the S&P 500 since inception.

Risk arbitrage is a strategy that seeks to exploit pricing inefficiencies around the announcement of corporate activity in public markets, such as mergers and takeovers. ABCA employs a disciplined strategy of investing only in announced deals with known terms and an attractive risk profile. The investments are made systematically using a process and database first put in place in 1998.

The strategy aims to exploit the 'spread' between the announced terms and the current market price, which is often overly discounted due to an excess of selling pressure as institutional managers rebalance their portfolios following the announcement of public offers. This is a low-beta strategy (we estimate a beta of 0.1 based on the fund's track record) while generating returns several percentage points above prevailing cash rates. This expected return is similar to that of high-yield bonds but has the advantage of improved liquidity.

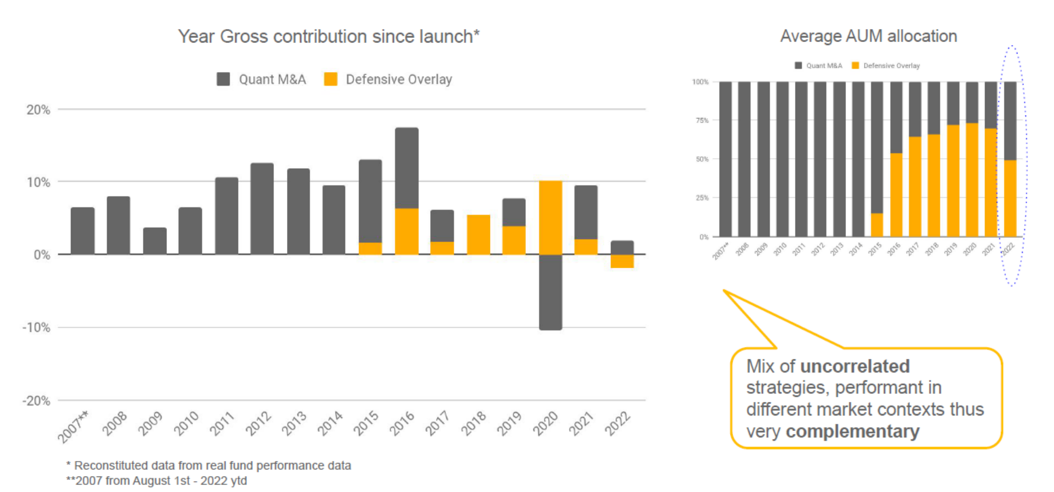
The emphasis is on avoiding losses and generating returns through a diversified portfolio of around 50–100 equal weighted holdings, in contrast to traditional risk arbitrage portfolios, which may have as few as 15–25 holdings and a significant skew towards just a few names perceived by the manager as especially attractive.

The diversification policy has historically significantly improved the Sharpe ratio (a measure of the risk-adjusted return) compared to competing funds. Its long-term performance remains highly competitive while volatility is significantly reduced. The overarching portfolio management principle is to quickly identify bad deals but systematically underwrite good ones over the long term, rather than engaging in deal speculation or generating a spectacular return in any single year.

By its nature, this process has more human interaction compared to the systematic trading undertaken within the reversion strategy and there are six analysts working on the portfolio at any one time. Importantly, the strategy does not involve an in-depth fundamental analysis of the entities involved in the M&A deal, but rather a factor analysis developed by ABCA over the years.

A key risk for risk arbitrage-based portfolios is a sudden increase in market volatility. Many of the participants in the market (such as hedge funds or proprietary dealing desks) are leveraged. While in normal markets these participants provide liquidity to institutional fund managers, they can also suffer from their own liquidity constraints in stressed markets. This gives rise to the phenomenon of highly correlated spread-widening, most recently during the initial stages of the COVID-19 pandemic. At such times, there can be significant drawdowns in traditional risk arbitrage portfolios. However, inherent in the design of the ABCA Opportunities Fund is a significant allocation to the ABCA Reversion Fund and a recently introduced equity statistical arbitrage strategy (referred to by the company as a 'defensive overlay'). Moreover, risk arbitrage returns were affected by the standstill in the M&A markets immediately after the COVID-19 pandemic outbreak (March to July/August 2020).

Exhibit 3: ABCA Opportunities Fund* – strategy contribution



Source: ABC arbitrage. Note: *Qualifying Investor Fund.

The inclusion of returns from the ABCA Reversion Fund acts as an effective hedge against the risk of market dislocation. When volatility increases and risk arbitrage spreads widen, the performance of the liquidity-driven component of the portfolio is expected to improve in a non-linear manner. This hedges the expected spread widening in M&A deals but without incurring the performance hit of maintaining a long volatility option-based hedge. For example, during the COVID-19 pandemic, ABCA Opportunities was down only 4.4% versus a loss of 13.1% for the HFRI Event Driven Index. The year 2022 was characterised by subdued M&A activity amid uncertainty over the extent of economic slowdown, making it difficult to estimate future cash flows and valuations, on top of curbed access to debt financing. As the environment stabilises, we expect an uptick in corporate actions, which should translate to a better performance for ABCA Opportunities Fund.

Quartys: Capacity constrained strategies and incubator

Investors in ABCA also benefit from the returns of strategies that are capacity constrained and unsuitable for marketing to a broader audience. These high-return activities reside within the wholly owned subsidiary Quartys and account for roughly 30% of the entity's invested capital. A further 30% of the capital of Quartys is invested in 'incubating' strategies. In this way, ABCA can use its own internal seed capital to invest in new strategies to develop expertise and a track record before inviting external capital to participate.

Once a strategy has been approved for inclusion in one of the ABCA funds, to avoid conflicts of interest, the original activity of Quartys ceases. Quartys will then make a direct investment in the new strategy alongside external investors in the fund. The remaining 40% of Quartys's capital is invested in the external funds in this manner, ensuring the firm retains an equity interest in the success of the strategy, which provides meaningful comfort to third-party investors.

Quartys also develops strategies that are later offered by ABCA to investors in individual managed accounts. As at end-December 2022 ABCA managed €40m in those accounts, and the group expects to accelerate the AUM growth of these products on the back of regulatory developments. Based on our discussion with management, we understand that the regulator has recently approved a certain overlap of strategies between these managed accounts, whereas so far ABCA had to offer a unique solution to each client. This change will enhance ABCA's offering and should facilitate new client acquisition.

Management

ABCA's executive team consists currently of CEO **Dominique Ceolin,** who co-founded ABC arbitrage in 1995, and four members of the executive committee. Dominique is a qualified actuary and holds an advanced degree in mathematics and information technology. He holds several positions across ABC arbitrage group, and resigned from his salaried positions in 2018, so there is no longer a combination of an employee and an executive function.

The executive team is supported by a board of non-executive directors consisting of five members, two of whom are independent. Additionally, a representative of the works council is invited to all board meetings as a non-voting participant. All board members are appointed for four-year terms.

Dominique Ceolin acts as chairman of the board alongside his duty as ABCA's CEO since 1997. **Xavier Chauderlot** is the current representative of Aubépar Industries (a co-founder of the company, which still owns c 12% of the outstanding shares) and acts as director at Quartys. The two board members who fulfil the criteria of an independent director, as defined by MiddleNext's corporate governance code, are **Sophie Guieysse** and **Isabelle Maury**. Sophie has extensive experience as a member of the boards of directors and director of human resources for large international companies, as well as in French ministerial cabinets in the urban development and public infrastructures areas. She has been an ABCA board member since 2021. Isabelle was appointed in 2022, and during her career she has held various leadership positions in investment risk management and governance. **David Hoey** joined the group in 1996 and up until his appointment as member of the board at the recent AGM acted as a deputy CEO. As he owns 5.8% of ABCA's shares, he does not meet the criteria for an independent director. He holds a master's degree in accounting and finance with a major in information technology.

Exhibit 4: ABCA's board of directors

Board member	Date of appointment	Remuneration in FY22	Shareholdings
Dominique Ceolin	10 October 1997	€872,697*	4.4% (16.3%)**
Xavier Chauderlot (Aubépar Industries)	1 June 2012	€21,900	11.9%
Sophie Guieysse	11 June 2021	€15,675	0.002%
Isabelle Maury	10 June 2022	€19,400	0.002%
David Hoey	9 June 2023	€489,547*	5.8%

Source: ABC arbitrage. Note: *Full renumeration amounts, including Dominique Ceolin's role as CEO and David Hoey's role as deputy CEO in 2022. **Dominique Ceolin holds 4.4% shares outstanding directly, and a further 11.9% shares are owned by Financière WDD, in which Dominique Ceolin holds 50.01%

Valuation

We value ABCA's shares using a DCF approach. For the purposes of our valuation, we remove any trading income and gains arising from earlier income/gains recycled back into the trading activity (in order to avoid double-counting of cash flows). We apply an 8.5% cost of equity, which, given no debt at the holding level, is also our weighted average cost of capital (WACC) estimate. We assume a 2% terminal growth rate. Consequently, we arrive at a fair value in our base case scenario of €6.84 per share, 15% above the current share price. In our base case scenario, we assume that ABCA's third-party AUM will reach c €434m by FY25 and €617m by FY27 (vs c €185m at end-2022).

Our forecast implies a P/E ratio of 13.0x on 2024 EPS. As a point of reference, Man Group, Virtu Financial and Flow Traders currently trade in an 8.4–9.3x range based on Refinitiv consensus estimates. However, we need to note that none of the companies may act as a direct comparator; for instance some of the peers have no meaningful third-party assets under management.

In our bear case scenario, we value ABCA as it is – without any additional capital raised from third-party investors – and we arrive at a fair value of €5.76 per share (3% downside). Alternatively, assuming that ABCA will be able to attract external capital in line with its Springboard 2025 target in our bull case scenario, we arrive at fair value of €8.32 per share, which suggests 40% upside to the current share price.

Exhibit 5: ABCA's DCF valuation model

€m, unless otherwise stated	FY23e	FY24e	FY25e	FY26e	FY27e
EBIT	15.4	27.5	28.2	29.7	31.0
Excess gains adjustment	0.0	(0.9)	(1.8)	(2.9)	(3.9)
Tax rate	1.0%	1.0%	1.0%	1.0%	1.0%
Net operating profit less adjusted taxes	15.2	26.4	26.1	26.6	26.8
D&A	1.7	1.7	1.7	1.7	1.7
Change in working capital	0.0	0.0	0.0	0.0	0.0
Capital expenditures	(1.7)	(1.7)	(1.7)	(1.7)	(1.7)
Free cash flow to firm	**15.2**	**26.4**	**26.1**	**26.6**	**26.8**
Discounted free cash flow to firm (DFCFF)	**14.1**	**22.4**	**20.5**	**19.2**	**17.9**
WACC	**8.5%**				
Terminal growth rate	**2.0%**				
Sum of DFCFF	94.0				
Terminal value	282.1				
Enterprise value	**376.1**				
Net debt/(cash) end-2022	(14.2)				
Equity value	**390.3**				
Share count (fully diluted) (m)	59.8				
Fair value per share (€) end-2022	**6.53**				
Fair value per share (€) current	**6.84**				
Current share price (€)	5.93				
Upside/(downside)	***15%***				

Source: Edison Investment Research

Exhibit 6: ABCA's valuation sensitivity to WACC assumption

WACC	5.5%	6.5%	7.5%	8.5%	9.5%	10.5%	11.5%
Fair value per share (€)	12.44	9.74	8.02	6.84	5.97	5.31	4.79

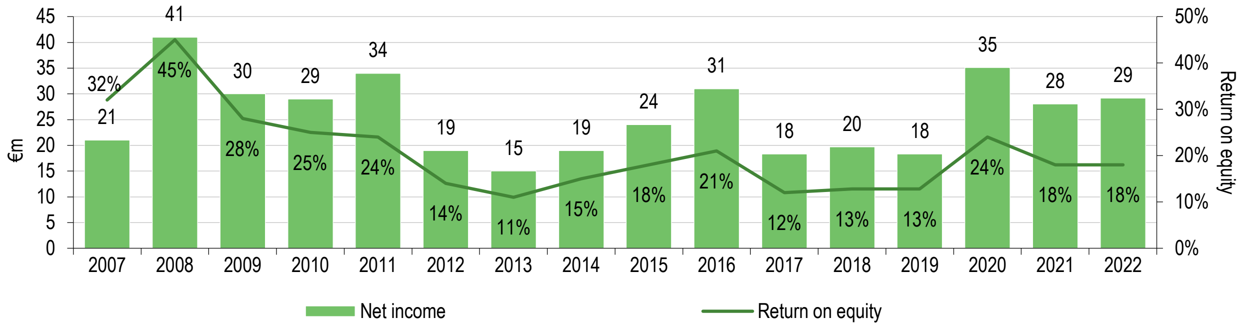
Source: Edison Investment Research

Financials

A solid 22% ROE over the last 15 years

The success of ABCA's proprietary algorithms has provided a consistently strong ROE of 22% pa over the past 15 years (see Exhibit 7) and an ROE in excess of 10% over 28 years.

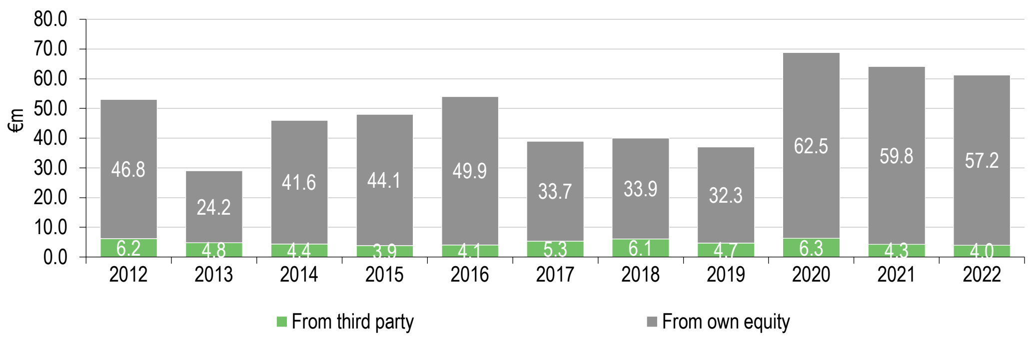
Exhibit 7: ABCA's historical net income and ROE



Source: ABC arbitrage

Principal investing still accounts for c 90% of the group's revenue, with the rest coming from management and performance fees from third-party AUM, see Exhibit 8. Given the effectiveness of the systematic algorithms currently employed, there is a high correlation between realised equity market volatility in any given year and the potential returns for the systematic strategies (see Exhibit 2 above). When market volatility is high, short-term arbitrage opportunities are more prevalent and ABCA's short-term liquidity providing strategies become increasingly profitable. In contrast, when volatility is low there are fewer pricing discrepancies to exploit and profitability declines. This should be regarded as an attractive attribute, as it provides ABCA shareholders with exposure to returns in both bull and bear markets. On the other hand, the key return driver for its event-driven strategy is the number of announced M&A deals in public markets, which tends to increase during periods of positive financial market development.

Exhibit 8: ABCA's revenues from internal equity and fees on third-party AUM



Source: ABC arbitrage

How to read ABCA's financial statements

It is important to note that ABCA's investing subsidiary (Quartys) is considered as investment entity due to the nature of its business and as such is consolidated via an equity method, despite being fully owned by ABCA. Therefore, it is presented in ABCA's consolidated statements as a financial asset at fair value through profit or loss. The value of Quartys is recognised at its book value of equity and is not subject to any fair value estimates. This means that net income generated by Quartys is recognised as a net gain on financial assets (and presented in the revenue line). Additionally, as ABCA's management entities are consolidated in full (see Exhibit 1), the fees charged on Quartys's capital are recognised in revenues from investment services fees.

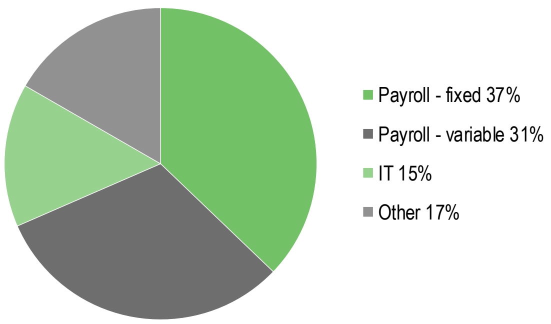
This way of consolidation also has implications for ABCA's income tax rate, as the majority of the tax is paid by Quartys and is not visible on ABCA's income statement. On top of that Quartys is domiciled in Ireland and subject to a lower corporate tax rate than France.

People are ABCA's first priority and key cost item

ABCA employed 95 technologists in FY22 (up from 87 in FY21), building innovative trading systems and asset management strategies. Payroll costs are ABCA's main expense item, representing roughly two-thirds of the total operating expenses. A significant part of employee compensation is performance-linked (see Exhibit 9), strongly aligning employees' interests with the group's success. In 2022, total human resources costs amounted to €23m, of which €10m was in the form of bonuses and profit sharing.

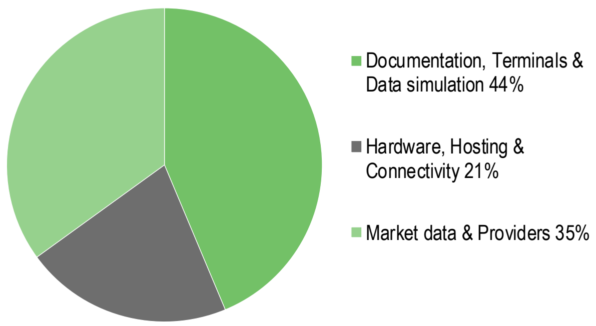
ABCA invests considerable resources in maintaining its edge in the market with a technology and data budget that is a significant proportion of revenues (see Exhibit 10). The majority of current trading activity is based on models that have been modified in the past five years. Key to the success of the business has been the development of a robust and proprietary IT infrastructure. In contrast to interfacing software packages from external suppliers, this enables a fully integrated systematic trading workflow, which operates on a 24-hour basis. Full system integration reduces operational risk and offers a competitive advantage from the feedback of trade information in real time. There are seamless handovers between colleagues based in Europe and Singapore, while the end of day positions are marked to market at 10pm Paris time, after the US close.

Exhibit 9: ABCA's 2022 operating costs



Source: ABC arbitrage

Exhibit 10: ABCA's 2022 IT-related costs

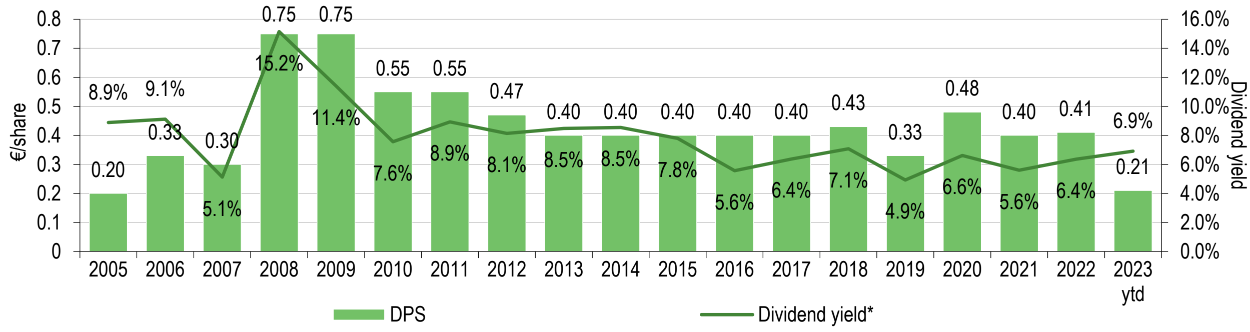


Source: ABC arbitrage

Most of generated income/gains paid out as dividends

Given the short holding periods, close to all of the returns generated by ABCA's arbitrage business represent realised cash income, and over last six years the cash flow from operations was roughly equal to the reported net income. Almost all of the cash income is in turn distributed to shareholders (the cumulative dividend payout ratio to net income stands at 97% over the last five years). ABCA pays dividends quarterly, with the last 12 months' payments implying a healthy dividend yield of 6.9% based on the current share price. We need to note, however, that based on our forecast for 2023 profits, the prospective yield stands at 5.1%.

Exhibit 11: ABCA's historical dividend payments



Source: ABC arbitrage, Refinitiv, Edison Investment Research. Note: *Calculated as dividends distributed in a given year compared to share price at the end of a year.

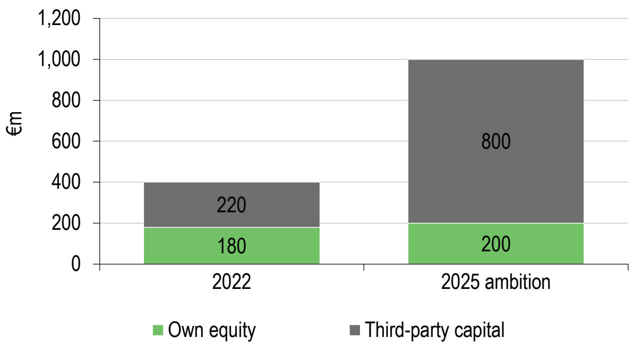
Springboard 2025

Recently, ABCA announced its 'Springboard 2025' strategic plan, building on the previous 'ABC 2022' plan. Its focus is on increasing the number of strategies to enhance diversification (by region and asset classes) and increasing the capacity for third-party assets. Management plans to develop an extensive but selective catalogue of products and management vehicles for third-party capital.

ABCA expects to achieve at least a 10% ROE over the coming years, with the ambition of an ROE over 15%, which assumes that volatility, corporate actions and traded volumes stay at their average levels from the last 10 years. This compares to the ROE of 22% that ABCA generated on average throughout the last 15 years. Taking into account the planned AUM expansion, this translates to a cumulative net income of €100m over the next three years, an 8% increase over the 2020–22 cumulative income (we assume €70m, with the difference vs Springboard 2025 expectations coming partly from the expected weaker FY23 results). ABCA plans to distribute c 80% of its profits in dividends, somewhat below its historical payout ratio, as it plans to redirect part of the gains into seed capital for launching new strategies. At the same time management does not intend to lower the DPS below €0.30 in any given year – in our forecast we assume that the dividend in 2024 will be partly paid out of capital.

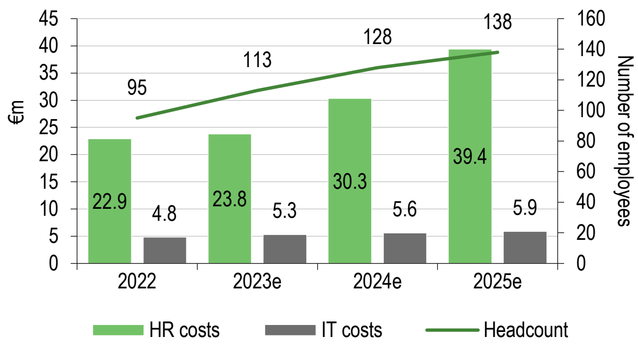
The group has committed to a plan to expand AUM to €1bn from €400m currently. ABCA's ambition is to increase its third-party AUM to €800m by the end of 2025, which implies attracting around €580m of new capital (including capital gains), which we estimate would generate an incremental €9m in management fees for the firm, along with any performance fees. It has a dedicated sales team of three people and developed capacity to facilitate accommodating €1bn in AUM within the 'ABC 2022' plan. To facilitate the achievement of the above-mentioned objectives, ABCA plans to increase its headcount by 45% (see Exhibit 13).

Exhibit 12: ABCA's 2025 target AUM



Source: ABC arbitrage

Exhibit 13: Springboard 2025 – expected operating cost evolution



Source: ABC arbitrage

Forecasts

Below we present a summary of our forecasts for ABCA. We assume a slight increase in gains generated on ABCA's internal equity (based on an ROE of c 16%, except for 2023 due to temporary widening of pre-merger spreads as described below) and a visibly higher contribution from third-party fees on the back of the growing AUM. At this stage, we assume a lower third-party AUM level by FY25 than the €800m implied by the management guidance, as new capital inflows are yet to gain traction (see Exhibit 15). We note that ABCA's 2022 Ambition aimed to reach total AUM (internal equity and third-party capital) of €1bn by end-2022, while recent underwhelming performance has led to meaningful capital outflow in 2022 – mostly on the back of one large client withdrawing its investment. Some of the factors that may have contributed to the weaker capital flows until the end of last year include:

- a weaker performance than the historical average of the funds – see the company description section above for details; and
- a limited product offering – as ABCA's cryptocurrency-focused products were not rolled out due to recent turmoil and weak sentiment towards the asset class.

That said, we believe that ABCA's expertise in generating solid returns from market-neutral strategies, coupled with improved marketing efforts and a broadened product offering, should help ABCA attract sizeable third-party capital. As central banks have turned to monetary tightening and the impact of an economic slowdown is being evaluated and priced in by the markets, we believe the outlook for arbitrage returns has improved, and ABCA's offering may be more appealing to investors. Additionally, ABCA has devoted resources to attract third-party capital: it has formed a sales team dedicated solely to fund-raising, as well as implemented a CRM system and reporting tools to enable better mapping and follow-up with potential customers.

In our forecasts, we assume that the ABCA Reversion Fund delivers an 11% gross return pa; for the ABCA Opportunities Fund we expect an 8% gross return pa (starting in 2024, when we expect M&A activity to return to normal). Our target return assumptions are above recent performance because we expect a normalisation of trading, as described in detail earlier in the note, whereas they are slightly above pre-COVID-19 average returns (2011–19 net returns were 5.6% and 7.2% pa, respectively) due to the higher interest rate environment. We note that risk arbitrage tends to deliver returns similar to those of high-yield bonds, which have currently increased to 8.9% (S&P US High Yield Corporate Bond Index) compared to 4–6% in 2017–22.

Meanwhile, so far in 2023 the market volatility is relatively low, while M&A transactions have not accelerated to the extent to fully offset lower revenues from volatility-based strategies. This was further exacerbated by recent Federal Trade Commission (FTC) action marking the first time in more than a decade that the US antitrust regulator has sought to block a deal in the pharmaceutical sector (Amgen's acquisition of Horizon Therapeutics). This has led to recent widening of pre-merger spreads and weighed on ABCA Opportunities' performance, which, however, the manager considers temporary.

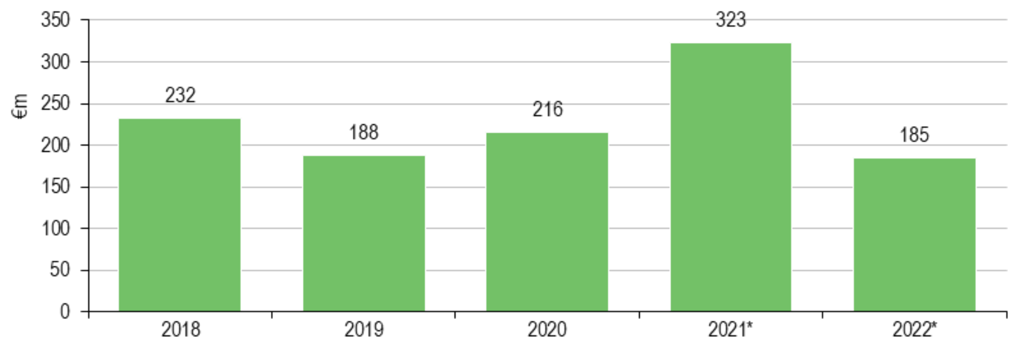
ABCA Reversion delivered a 1.2% net return in the year to end-May (compared to a 3.1% decrease in 2022) and ABCA Opportunities 2.9% (vs a 2.6% decrease in 2022). Therefore, we assume FY23e gross returns below the historical average, which, together with the higher cost base driven by ABCA's expansion plans, represent a temporary drag on ABCA's ROE.

Exhibit 14: Forecasts summary

€m, unless otherwise stated	2022	2023e	2024e	2025e	2026e	2027e
Revenues – internal equity	57.4	37.9	54.4	54.9	55.4	55.9
Third-party AUM	185.0	244.8	350.8	434.2	523.1	617.0
Revenues – third-party capital	4.0	4.6	8.5	10.9	12.7	14.5
As % of average AUM	*1.4%*	*2.1%*	*2.9%*	*2.8%*	*2.7%*	*2.5%*
Total revenue	**61.4**	**42.5**	**62.9**	**65.8**	**68.2**	**70.4**
Operating expenses excl. D&A	(30.6)	(25.4)	(33.7)	(35.9)	(36.8)	(37.7)
EBITDA	**30.8**	**17.1**	**29.2**	**29.9**	**31.4**	**32.7**
Net income	**29.2**	**15.2**	**27.2**	**27.9**	**29.3**	**30.7**
EPS (€)	0.49	0.25	0.46	0.47	0.49	0.51
ROE	*18%*	*9%*	*17%*	*17%*	*17%*	*17%*

Source: ABC arbitrage, Edison Investment Research

Exhibit 15: ABCA's third-party assets under management



Source: ABC arbitrage. Note: *The 'marketing AUM' which uniformizes the AUM from a fee perspective stood at €225m at end-2022 and €363m at end-2021.

Sensitivities

We have identified several sensitivities relevant for ABCA's business. These include:

Attracting new capital

ABCA has set an ambitious plan to attract c €580m of new third-party capital to its existing strategies and those planned to launch. It has dedicated a team to fund-raising and intensified its marketing efforts, but the success of acceleration has yet to be proven. We note that the funds are intended for qualified investors only and the minimum ticket size is set to €1m, which excludes regular retail investors, whereas the relatively small size of its funds may discourage some large institutional investors whose minimal assumed ticket size would represent a large part of the AUM of a given ABCA fund. Therefore, ABCA may have to focus on the lower end of the institutional investors universe (eg family offices).

Technological disruption

We believe ABCA continues to face competition from other market players in its capacity-constrained strategies, which could intensify if the group is unable to invest to match competitors' innovations over time. Nevertheless, the group has a strong track record of evolving to keep pace with market developments over the past 25 years. With a long and successful history in the disciplines of arbitrage, statistical modelling and IT development, management believes recent advances in AI are unlikely to have a significant impact on the profitability of its strategies. The very nature of its activities means that ABCA was a leader in 'big data' before it became a catchphrase, while the group continues to invest in and develop new statistical models according to the evolution of financial market conditions. Management believes it is the provision of liquidity rather than any specific technology that provides a margin; early adopters of new AI-based techniques that do not adhere to this principle may find returns over the medium term elusive. Having said that, to maintain its competitive edge, ABCA continues to adopt new technologies in its operations, including AI.

Increasing efficiency of the markets

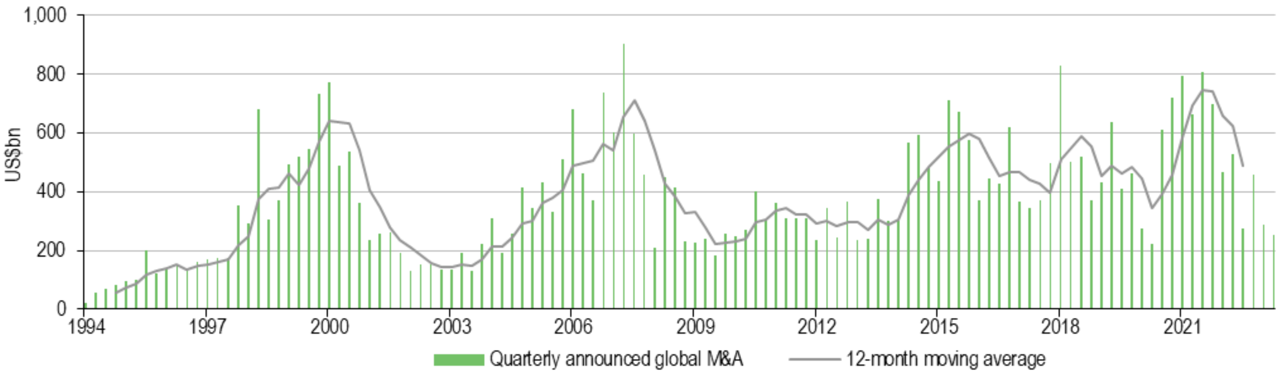
Historically, the evolution of new market opportunities has more than compensated for the loss of older strategies where returns have faded as markets become more efficient. ABCA's competitors include certain activities of Winton, Two Sigma, Renaissance Technologies and Jane Street and a wide variety of other market participants that provide liquidity in global markets. For its higher frequency and ETF trading activities, ABCA's operations are somewhat similar to Virtu Financial and Flow Traders, although these companies operate strategies of much higher frequencies.

Cyclicality of corporate actions

The return from ABCA's Opportunities strategy is dependent on the level of global M&A volumes, which have recently been constrained by deteriorating debt funding conditions, with further headwinds coming from the well-publicised issues in respect of US regional banks. We would not therefore expect a meaningful improvement in M&A volumes until at least the final quarter of 2023. Corporate willingness to engage in large-scale M&A is in our view likely to return once the uncertainty over the depth and duration of the economic slowdown expected in 2023 becomes clearer.

That said, we note that from a macroeconomic perspective the recent tightening of financial conditions by global central banks provides a backdrop of increased volatility, which is likely to benefit systematic strategies, even as M&A activity is for now somewhat muted. Furthermore, we believe that companies can only defer M&A activity for a limited time, and M&A activity has historically proved highly cyclical, see Exhibit 16.

Exhibit 16: Recent global M&A volumes* are at a cyclical low



Source: Refinitiv, Edison Investment Research. Note: *Includes announced deals over US$750m in valuation.

For event-driven trading activity, the strategy performs best when there is a plentiful supply of sufficiently liquid M&A deal targets, a situation typically associated with benign market conditions. However, when there is also strong risk appetite among other market participants such as hedge funds for event-driven investments, deal spreads may compress to unattractive levels.

Cost of capital

There is no direct interest rate exposure although periods of low interest rates like those of the prior decade can be associated with increased market trading activity and higher volumes of shares traded. While a period of higher interest rates may not affect the results of ABCA directly, should there be a corresponding decline in market liquidity, the opportunity set may diminish.

For product launches and internal strategies based on digital assets, a sustained period of tight monetary policy could crimp investor demand and affect the liquidity in digital asset markets. Potential arbitrage returns in this space appear to be relatively high compared to traditional asset classes and as the market matures these may decline, which would need to be offset by growth in AUM for profits to be sustained. The regulatory environment for digital assets and collective digital asset funds is relatively immature, with the attendant risk of product launch delays and restrictions on distribution and investment activity. The impact of regulations on digital assets differs by jurisdiction: the US is looking less encouraging with the multiple enforcement actions of the Securities and Exchange Commission (SEC) and the dispute over regulatory oversight between the SEC and the Commodity Futures Trading Commission, while in the EU the Markets in Crypto Assets (MiCA) regulation recently provided more clarity.

Change of regulations with respect to leverage and stock lending

The group relies upon its ability to trade at the lowest possible cost with leverage and stock lending available on commercial terms. Regulatory or fiscal changes could potentially have an impact on the business model, even if at the present time the probability of new short-selling restrictions or transaction taxes appears remote.

Market risk

ABCA's core activities by nature are hedged against directional equity market risk. The primary commercial sensitivity for its short-term trading activity is realised volatility, where there is a positive linear relationship between expected returns and realised equity market volatility. Nevertheless, unanticipated shifts in the market correlation structure can create short-term challenges, as proved in 2022 when the return on the ABCA Reversion Fund was significantly lower than that implied by the prevailing level of S&P 500 volatility.

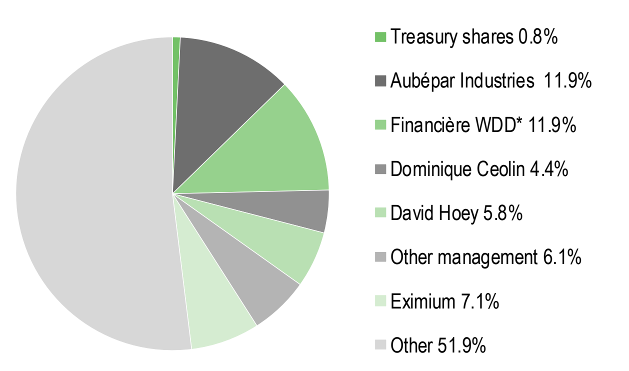
Capital structure

ABCA's share capital consists of 59.6m ordinary shares, of which 59.1m are outstanding. In 2022 the weighted average fully diluted shares stood at 59.8m, implying potential future dilution of just 0.3%. Importantly, in the Springboard 2025 plan ABCA assumes no further scrip dividends.

As at end-2022, 16.3% of the outstanding shares were held by the executive top management of ABCA (although this included David Hoey's 5.8% holding; he has since stepped down from his role as deputy CEO at the recent AGM). A further 11.9% was owned by Financière WDD, which is ultimately controlled by ABCA's CEO. Additionally, a further 11.9% is held by Aubépar Industries, which is a co-founder of the company that designates one board member of ABCA. The total direct and indirect shareholding of the management team therefore is 40%. On one hand, this provides strong alignment of interests between shareholders and the management. On the other hand, we believe that ABCA could benefit from a broadening of its shareholder register in the long run, not least to avoid a stock overhang when the founders eventually decide to exit or retire.

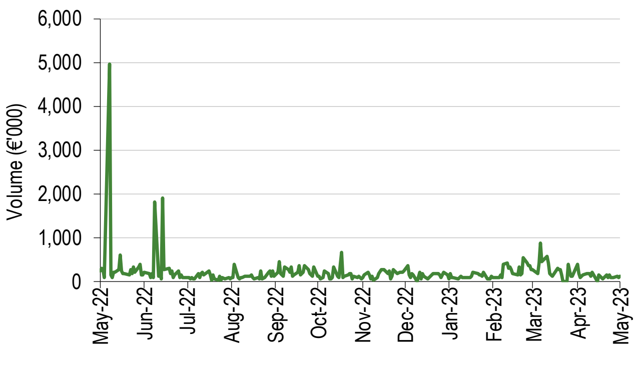
In June 2022 the board was authorised to conduct a share buyback programme with the maximum amount to be purchased set at €20m and the number of shares acquired by the group may not exceed 10% of its capital. As at end-2022, the group used c €4m out of the programme and held 0.8% of the shares in treasury.

Exhibit 17: Major shareholders



Source: ABC arbitrage. Note: *Dominique Ceolin owns 50.01% of the entity.

Exhibit 18: Average daily volume



Source: Refinitiv

Exhibit 19: Financial summary

Year end 31 December, IFRS, €000s	2018	2019	2020	2021	2022	2023e	2024e	2025e	2026e	2027e
Income Statement										
Investment services fees	16,757	14,423	22,504	59,921	27,438	24,041	35,105	37,601	39,574	41,444
Net gain/loss on financial instruments at fair value through profit or loss	23,133	22,520	46,023	4,134	33,711	18,101	27,449	27,842	28,229	28,608
Total revenues	**40,232**	**37,246**	**69,108**	**64,342**	**61,437**	42,507	62,918	65,809	68,168	70,417
Payroll costs	(12,778)	(11,654)	(25,519)	(19,823)	(21,518)	(16,679)	(24,263)	(26,079)	(26,763)	(27,436)
Administrative expenses	(6,214)	(6,723)	(5,467)	(5,769)	(6,249)	(7,501)	(8,055)	(8,410)	(8,766)	(8,942)
Other operating income/(expenses)	(865)	986	(455)	(1,356)	(2,535)	(1,233)	(1,360)	(1,407)	(1,264)	(1,303)
EBITDA	**20,032**	**19,552**	**37,086**	**37,107**	**30,847**	**17,094**	**29,240**	**29,912**	**31,375**	**32,736**
EBIT	19,118	18,072	35,467	35,371	29,156	15,403	27,549	28,221	29,684	31,045
Pre-tax profit	19,318	18,073	35,440	35,353	29,091	15,336	27,482	28,154	29,617	30,978
Net income	**19,679**	**18,339**	**35,093**	**28,038**	**29,151**	**15,182**	**27,207**	**27,873**	**29,322**	**30,669**
EPS €	**0.34**	**0.31**	**0.60**	**0.48**	**0.49**	**0.25**	**0.46**	**0.47**	**0.49**	**0.51**
DPS €	0.43	0.33	0.48	0.40	0.41	0.30	0.37	0.37	0.39	0.41
Balance Sheet										
Property, plant and equipment	973	1,057	1,392	1,166	1,236	1,236	1,236	1,236	1,236	1,236
Right-of-use assets	0	1,815	932	5,385	4,771	4,771	4,771	4,771	4,771	4,771
Intangible assets	188	174	126	99	118	118	118	118	118	118
Non-current financial assets	603	620	625	630	669	669	669	669	669	669
Deferred tax assets	389	167	113	269	79	79	79	79	79	79
Non-current assets	**2,153**	**3,832**	**3,188**	**7,550**	**6,873**	**6,874**	**6,874**	**6,874**	**6,874**	**6,874**
Financial assets at fair value through profit or loss	133,901	127,363	150,319	133,986	154,175	155,177	164,771	174,879	180,356	186,213
Other accounts receivable	8,690	7,155	10,569	25,410	12,051	12,051	12,051	12,051	12,051	12,051
Current tax assets	281	214	215	0	0	0	0	0	0	0
Cash and cash equivalents	6,958	7,789	8,767	18,252	14,226	10,642	6,489	1,956	2,343	2,620
Current assets	**149,830**	**142,521**	**169,870**	**177,648**	**180,452**	**177,870**	**183,311**	**188,886**	**194,750**	**200,884**
Total assets	**151,983**	**146,353**	**173,058**	**185,198**	**187,325**	**184,744**	**190,185**	**195,760**	**201,624**	**207,758**
Share capital	936	936	936	949	954	954	954	954	954	954
Share premium	59,472	47,517	47,517	39,752	41,441	41,441	41,441	41,441	41,441	41,441
Net income	19,679	18,339	35,093	28,038	29,151	15,182	27,207	27,873	29,322	30,669
Retained earnings	66,204	73,110	70,484	91,285	90,110	101,498	94,914	99,823	104,239	109,025
Total equity	**146,291**	**139,902**	**154,030**	**160,024**	**161,656**	**159,075**	**164,516**	**170,091**	**175,955**	**182,089**
Lease liabilities	0	0	0	1,133	1,301	1,301	1,301	1,301	1,301	1,301
Taxes payable	0	0	0	5,431	5,394	5,394	5,394	5,394	5,394	5,394
Other liabilities	5,642	4,161	17,879	14,356	14,575	14,574	14,574	14,574	14,574	14,574
Current liabilities	**5,642**	**4,161**	**17,879**	**20,920**	**21,270**	**21,269**	**21,269**	**21,269**	**21,269**	**21,269**
Non-current liabilities	**50**	**2,292**	**1,148**	**4,255**	**4,400**	4,400	4,400	4,400	4,400	4,400
Total equity and liabilities	**151,983**	**146,355**	**173,057**	**185,199**	**187,326**	**184,744**	**190,185**	**195,760**	**201,624**	**207,758**
Ratios										
ROE	13.3%	12.8%	23.9%	17.9%	18.1%	9.5%	16.8%	16.7%	16.9%	17.1%

Source: ABC arbitrage, Edison Investment Research

Contact details	Revenue by geography
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Management team

Chair and CEO: Dominique Ceolin	CFO/CCO: Gaëtan Fournier
Dominique Ceolin is chairman and CEO of ABC arbitrage. After qualifying as an actuary (Institut des Actuaires Français) and obtaining a diploma in mathematics and information technology (DEA), Dominique joined ABN AMRO Securities France in 1994 where he participated in developing the Domestic Arbitrage business. In 1995, he was one of the co-founders of ABC arbitrage and took responsibility for the R&D and Market Risks departments. He is a member of the Institut des Actuaires Français (the association of French actuaries).	Gaëtan Fournier graduated from NEOMA Business School and holds a DSCG diploma. He began his career as a financial auditor at Ernst & Young with a specialisation in the middle market. After five years, he joined the ABC arbitrage group in 2012. In 2016, he took over as head of the finance and internal control department, before being appointed group secretary general in 2020.
CEO of ABC arbitrage Asset Management: Alexandre Ospital	**CEO of Quartys: Marie-Laure Cillard**
Alexandre Ospital has an engineering background (ESTP) and joined ABC arbitrage in 1999, after one year in a consulting company. He was appointed head of the financial operations department in 2005. Since August 2013, he has been deputy director in charge of operations at ABC arbitrage Asset Management. In February 2020, he was appointed as COO before becoming in January 2022 CEO at ABC arbitrage Asset Management.	Marie-Laure Cillard is a graduate of École des Mines de Nancy. She joined ABC arbitrage in 1999, running statistical arbitrage strategies. She has been the CEO of Quartys, based in Dublin, Ireland, since 2014.
CEO of ABC arbitrage Asset Management Asia: Xavier Boutin	
Xavier Boutin is a graduate of École des Mines de Nancy. He joined ABC arbitrage in 1999, running statistical arbitrage strategies. He has been the CEO of ABC arbitrage Asset Management Asia, based in Singapore, since 2014.	

Principal shareholders	(%)
Aubépar Industries	11.9
Financière WDD*	11.9
Eximium	7.1
David Hoey	5.8
Dominique Ceolin	4.4
Other management	6.1
Other	51.9

Note: *Dominique Ceolin holds 50.01% in Financière WDD.

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