PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – OCTOBER 2019

The Pender Corporate Bond Fund returned -0.3% in October. Despite strong equity markets during the month, investor nervousness in credit markets was apparent, with spreads in the lower ranges of the credit rating scale blowing out to year-to-date highs.

An example of the risk-off effect on the Fund was a decline of over 6% in the 2023 notes of SunPower Corporation. SunPower, the North American leader in the distributed solar power business, published an earnings report that beat all estimates. The good news caused SunPower stock to rally, but not its credit, structural seniority notwithstanding. Other weakness was felt in some commodity-related credits, Paratek Pharmaceuticals and in Grupo Famsa USD bonds, where debt refinancing risks were in focus. We are watching all these lines carefully, but we remain broadly constructive, adding at lows.

Offsetting the weakness, to a degree, was a rebound in the prices of rate reset preferred shares, that rallied along with somewhat higher interest rates. Specific strength also came from a couple of retail credits. Rite Aid 2023 bonds gained on strong results and a tender offer to subordinated debtholders, while Bed Bath and Beyond rallied with improved sentiment surrounding a new CEO. Other strength came in the discounted convertible notes of Avadel, as the emergence of a new strategic holder of common shares increased the perceived likelihood of a par change of control.

Our Signposts along "the Road not Taken"
"Two roads diverged in a wood and I – I took the one less traveled by, And that has made all the difference." These few simple lines from Robert Frost's "The Road not Taken", are as close to encapsulating our investment approach as anything one might find in a finance textbook. Through a conscious focus on avoiding the fads and crowds of credit markets, we have found a lightly trodden path that has delivered some success. Some of the key factors that get us interested in a name include the following:

Depressed Multiples: Opinions about a company tend to move much more extremely than the underlying economic facts. And so enterprise value, or the sum of all equity and net debt values, can often double or halve within a year, despite a relatively consistent level of sales or operating profits. Our move into homebuilder credits in Q4 2018, for example, coincided with 40 quarter lows in the EV/Sales ratio of both Beazer Homes and LGI Homes. Subsequent events, which included a moderation in then-rising interest rates, led to a reversion toward the mean and double-digit returns for corporate bond investors in these companies.

Extremely Weak Sentiment: It is surprising, given how reliably contrary sell-side brokerage research recommendations are, that the reports are published at all, even more so that they are apparently read. However, we often find opportunity coincident with an unfavourable consensus of analysts. In March 2018, when we purchased bonds of Eldorado Gold, over two thirds of the 20 analysts covering the company were "hold" or "sell." After the enterprise value of the company has doubled in the past eighteen months, we now see "buys" outnumbering "sells" by a factor of 5-1. Coincident with the reset of these expectations, Eldorado Gold credit earned robust double-digits.

Enterprises Paring Back on Investments: Another measure we pay attention to is the investment cycle within an issuer. When times are good, investments in R&D, acquisitions and capital plants tend to outstrip the amortization of intangibles, indicating an expansive mindset. During stressful times, a company's management and board cut back on big ticket balloon payments. Circle the low ratio in the series of capital expenditures vs depreciation, or the low in R&D vs sales and you will often circle a turning point in the valuation trend of a company. In many cases this is the moment when the market's opinion moves from "getting worse" to "getting better".

Not contrary for contrariness' sake, but contrary given low prices, weak sentiment and management doing something about it. These are a few key ingredients in the opportunity set of a value investor in corporate credit.

New Positions…Frontdoor and Teva

In October we purchased a position in 6 ¾ 2026 bonds of Frontdoor Inc. Frontdoor, which in 2018 was spun out of its parent, Servicemaster Global Holdings, is a highly profitable home services business focused largely on the maintenance and repair of warranty-covered appliances and systems, such as heating and air conditioning equipment. In the past year, Frontdoor has been successful in an aggressive de-leveraging of its balance sheet. We consider the Frontdoor 2026 notes yielding approximately 5% to maturity to be attractive in the context of a one-year default probability estimated at approximately 0.1%.

This month, we also initiated a position in bonds of Teva Pharmaceuticals. Teva has been under pressure since its 2016 acquisition of the $40B generic business unit of Allergan plc, which stretched its balance sheet and was arguably not worth the price paid. Compounding problems for Teva was the patent expiry on a major branded drug, Copaxone, and an overhang related to potential claims against opioid drug manufacturers and distributors in the United States. At this point, with Teva's capital structure trading at decade low multiples and with a potential opioid claim resolution in sight, we find the capital structure attractive. In October we built a position in some Teva bonds trading at discounts to par, yielding between 7-8%. With solid free cash flow, management focussed on de-leveraging, and reasonably contained litigation risk, we believe Teva bonds now exhibit attractive risk/reward characteristics.

Fund Positioning

The Fund yield to maturity at October 31 was 5.9% with current yield of 4.6% and average duration of maturity-based instruments of 2.8 years. There is a 3.4% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.5% of the total portfolio at October 31.

Geoff Castle
November 6, 2019

[1] *F Class. For full standard performance information, please visit: http://www.penderfund.com/funds-and-performance*