PENDER
ALTERNATIVE ARBITRAGE FUND

MANAGER'S COMMENTARY – JANUARY 2022

Dear Unitholders,

The Pender Alternative Arbitrage Fund (PAAF) ended the month of January 2022 with a NAV of $10.15 per unit[1].

M&A activity is off to the races, with momentum from the record levels of global M&A activity last year continuing into 2022. Deal activity in January was the third highest on record, up nearly 28% from January 2021, and we expect a high level of deals to continue as conditions for M&A remain favourable[2].

The demand for M&A remains strong despite the volatility experienced during the month, evident by the four +$10B deals announced in January, including Microsoft Corporation's (NASDAQ: MSFT) $68.7B proposed acquisition of Activision Blizzard, Inc. (NASDAQ: ATVI). The tech sector continues to lead in M&A deal volume, with acquirers leveraging their strong balance sheets to deploy funds into strategic acquisitions. However, expectations of a hostile regulatory environment continue to weigh on spreads, particularly for large-cap technology sector deals, where spreads are indicating a lower market-implied probability of success. Merger arbitrage spreads ended the year at historically wide levels, with the expected spread for the 20 largest all-cash mergers in the US well in excess of 1000bps[3].

SPAC IPO issuance appears to be slowing, with several new offerings pulled during the month. The industry, however, is nowhere near an equilibrium, with nearly 600 SPACs searching and competing for targets under the constraints of a shortening timeframe until maturity, when they are required to return their capital to investors. With our observations of growth stock valuations crashing, particularly for earlier stage cash-burning companies that are prime targets for SPACs, the private to public company valuation gap has narrowed, while negative sentiment on the SPAC industry has weighed further on their share prices. The oversupply of SPACs, along with decreased expectations of announcing a value-creating deal, has initiated opportunities in some SPACs trading below trust value, where the yield-to-maturity exceeded 2.9%[4] at the end of January.

Portfolio Update

Market volatility had a material impact on equity and bond markets in January, with the S&P 500 briefly reaching correction territory and high-yield bonds posting their worst month since March 2020. The impact on merger arbitrage has been more muted, as the volatility experienced during the month appears to be more liquidity-driven and not reflective of economic weakness or distress in bond markets.

Merger arbitrage spreads widened during the month, reflecting higher interest rates and expectations of a more hostile regulatory environment. We believe this positions the Fund well for forward returns, as factors that influence successful deal closings, including financing certainty, are present, while we believe our positioning in smaller merger deals reduces our exposure to regulatory risk. The Fund took advantage of fluctuations in merger spreads during the month to add value by both adding or reducing exposure to merger deals.

Zynga Inc. (NASDAQ: ZNGA), Apria, Inc. (NASDAQ: APR), Castlight Health, Inc. (NYSE: CSLT), Vonage Holdings Corp. (NASDAQ: VG) Mimecast Limited (NASDAQ: MIME), Bluerock Residential Growth REIT, Inc. (NYSEAM: BRG), Vigil Health Solutions Inc. (TSXV: VGL), Spirit of Texas Bancshares, Inc. (NASDAQGS: STXB), Ortho Clinical

[1] All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.

[2] https://www.investmentexecutive.com/news/research-and-markets/global-ma-stayed-hot-to-start-2022/

[3] https://mergerarbitragelimited.com/spreads/

[4] https://spacinsider.com/stats/

Diagnostics Holdings plc (NASDAQGS: OCDX) and Xilinx, Inc. (NASDAQGS: XLNX), were among several new holdings for the Fund in January.

Magellan Health, Inc. (NASDAQGS: MGLN), Teekay LNG Partners L.P. (NYSE: TGP), CIT Group, Inc. (NYSE: CIT), Apollo Healthcare Corp (TSX: AHC), Casper Sleep Inc. (NYSE: CSPR) and Sol Cuisine Ltd. (TSXV: VEG) were among deals that closed during the month.

At the end of January, the Fund had 20 investments in small-cap deals under $2B with 15 of those deals under $1B. Vigil Health Solutions Inc. (TSXV: VGL) was the first take-out of the year for Pender's equity funds and was initiated as a position in the PAAF. As conditions remain present for strong M&A activity, we are excited by the prospects of future take-outs within our equity funds that we can leverage as prospective holdings in the PAAF.

As we have discussed previously, there are considerable benefits to leveraging Pender's small and mid-cap expertise within the PAAF. This is even more true in the context of the current market and regulatory environment where large-cap deals are attracting significant scrutiny. With merger spreads historically wide and volatility creating mispricing scenarios, we are finding attractive opportunities in smaller, less covered merger deals where we can potentially take advantage of Pender's deep expertise in investing in small companies.

Outlook

January demonstrated the difficulties of navigating the current market environment, with investors facing volatility in equity markets, a spike in bond yields, the prospect of interest rate hikes, central bank tightening and rising geopolitical tensions. Inflation hit a 30-year high in Canada, rising to 4.8%, and rose to a 39-year high in the US, with CPI at 7%. Global food prices have hit a 10-year high according to the UN, jumping 28% in 2021. Consumers are feeling the impact everywhere: at the gas pump, the grocery store, with rising housing costs and in their energy bills. While the Fed and Bank of Canada kept rates flat in January, placing concerns about the economic recovery ahead of fighting off inflation, they have both signalled that a rate hike should be expected in March.

Underpinned by high inflation and a strong labour market, we are likely in the early stages of a rate-hike cycle. We expect this environment to provide a favourable backdrop for merger arbitrage, given that it is among a limited number of investment strategies positively correlated to interest rates. Rising rates should widen out spreads on merger deals, increasing their expected return, in our view. The Fund's low correlation to equities and fixed income can also provide diversification benefits during a period with elevated volatility. With a strong environment for deal activity, historically wide spreads and a favourable track record for deal completions, we believe there is a compelling case for investors to diversify their portfolio exposure into merger arbitrage.

Amar Pandya, CFA
February 11, 2022

PENDER
PenderFund Capital Management Ltd.