PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – MAY 2022

The Pender Corporate Bond Fund finished a volatile May with a NAV total return of approximately -0.7%[1]. Lower bond prices in the portfolio more than offset the growing level of current income in the Fund that has reached its highest level since the spring of 2020.

There were several bright spots in the Fund during the period as credit positions in Treehouse Foods, Inc. (NYSE:THS) and Chemtrade Logistics Income Fund (TSX:CHE.UN) rallied on fundamental strength as those issuers reported positive earnings. Other holdings posting gains included Cenovus Energy Inc. (TSX:CVE) preferred shares, as that company's announcement of further debt redemptions highlighted the improved credit quality.

Notwithstanding these bright spots, most holdings repriced wider, with off-the-run names being particularly volatile. American Tire Distributors, Inc. Term Loan B, as an example of this class of holdings, priced nearly 4 points lower for the month. We continue to like this position.

Investing where we have conviction

The investment business is not short on optimistic chatter. But there is a difference between "optimistic because I have to be" and optimism that stems from deep conviction. The optimist with conviction can bear a degree of volatility because they have weighed the evidence and are comfortable with an investment's risk and return profile.

So let us not talk of optimism, but of conviction. In a market with an ugly tape, what parts of it strike us as being supported by firm underlying value? Where are the sleep-at-night holdings and the high-conviction risk positions that can build the gains of tomorrow?

Brick Houses: A big part of our conviction comes from healthy weights in the "brick houses" of the credit market. What's a brick house? How about Verisign, Inc. (NASDAQ:VRSN), the monopoly registrar of dot-com domain names? Currently capitalized at approximately US $20 billion, Verisign's debt represents less than 10% of total enterprise value. Interest is covered more than 10x by cash earnings. In this market, Versign's 2027 bonds yield more than 4.5% to maturity. Using Bloomberg's default probability method, Verisign's one-year default probability registers as 0.0001%. If you find it hard to have conviction in this market, think about Verisign's 2027 bonds.

Cream Puffs: This year has seen the return of a special class of credit opportunity that we like to think of as "cream puffs." The risk economics here are similar to the brick house credits but, due to accidents of circumstance – stale or absent ratings, or a lack of research coverage to name a couple – the cream puff bonds bump along with yields of approximately 10%. A case in point is the W&T Offshore, Inc. (NYSE:WTI) 9.75% 2023 2nd lien bond which sits atop a capital structure that has been re-invigorated by surging energy prices. Based on the current oil and gas pricing "strip", the company's net debt is just over 1x expected 2022 operating cashflow. Standard & Poors, in their last assessment of the W&T credit in July 2020, a mere three months after the extraordinary -$37 spot fixing in the oil market, rated this issuer CCC+. Were S&P to re-do their rating work today, we suspect they might be much more favourable. We have strong conviction here.

Credits with Pending Deals: High-quality yields are available in holding the credit of companies with agreed-to but pending takeover transactions. As an example, HP Inc.'s acquisition of Plantronics, Inc. (NYSE:POLY) puts the

[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.*

4.75% 2029 bonds on track for early redemption on attractive terms. While nothing is entirely inevitable, we have high conviction in the successful completion of this merger.

Compelling Risk/Reward: In these foregoing categories, we are finding rather attractive yield opportunities in situations where we believe we are taking on fairly low levels of capital risk. A curious reader may then ask, "What is the reward in this market for extending a little on the risk spectrum?" Not surprisingly, perhaps, we see situations in this market that offer, in our view, potentially even higher risk-adjusted returns. Looking at the 2% 2026 convertible obligation of Intercept Pharmaceuticals, Inc. (NASDAQ:ICPT), we see an interesting opportunity. The company has an approved drug, Ocaliva, which is used for the treatment of fatty liver disorders that already generates over $300 million in annual revenue. It also possesses - pro-forma the closing of a recent deal to monetize the international sales of Ocaliva - over $800 million cash. Moreover, the company stands on the precipice of an FDA decision on whether to extend the label of Ocaliva to allow its use in addressing the much more widespread NASH liver disease. Our shorthand estimates peg the value of Intercept at approximately $2 billion, even if the NASH extension is denied by the FDA. Total debt is only $729 million. With a value of almost 3x total debt, we find the 2026 notes trading near 66% of face value to be quite compelling.

In a market with a down-trending price bias, it is easy to lose faith. Non-specific optimism in such an environment is often not particularly helpful. But understanding and conviction, supported by a thorough line-by-line analysis, provides us with confidence in our positions and in the Fund as a whole. We realize that in the short-term, prices can be volatile. But within a reasonable time horizon, we have strong conviction that attractive returns may be achieved.

New Positions

In May, we added a position in the 2027 1st lien notes of Varex Imaging Corporation (NASDAQ:VREX). Based in Salt Lake City, Varex is a key supplier of components to the major manufacturers of medical scanning and imaging systems. We like Varex as a participant in an industry that has demonstrated consistent levels of demand through economic cycles, operated by a management team that is focused on de-leveraging its balance sheet. Priced to yield more than 7% to maturity, the 1st lien bond tops $243 million of a $1.3 billion capital structure. We view one-year default probability for Varex as less than 0.1%.

Also in May, we expanded our position in the 1st lien term loan of McDermott International Ltd. McDermott, which went through a restructuring in 2020, has significantly improved fundamentals as a recovery in major energy capital projects has expanded contracted order backlogs for the major engineering and construction players in the industry. We believe the term loan priced below 55% of face value represents compelling value.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at May 31 was 7.4% with current yield of 5.3% and average duration of maturity-based instruments of 3.4 years. There is a 2.6% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.9% of the total portfolio at May 31.

Geoff Castle
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PENDER
PenderFund Capital Management Ltd.

Standard Performance Information for Pender's Fixed Income Funds may be found here: https://www.penderfund.com/fixed-income/

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