



ALTERNATIVE ARBITRAGE FUND

MANAGER'S COMMENTARY – SEPTEMBER 2022

Dear Unitholders,

The Pender Alternative Arbitrage Fund (PAAF) was down 1.1% in September, bringing year-to-date performance to 1.1% with one-year performance of 2.9%¹.

M&A Market Update

M&A activity stalled in Q3 with a steep 55% decline in deal activity vs. the record M&A boom of last year. After eight consecutive quarters with over \$1T of global deal activity, Q3 saw M&A deals fall to roughly \$700M, bringing the year-to-date total to \$2.7T². M&A activity in North America, which is the geographical focus for the Fund, remains dominant, accounting for nearly 45% of global deal activity and leading the world in cross-border deals.

Despite the slowdown in deal activity, we believe the environment for merger arbitrage is still compelling. Merger arbitrage spreads remain at historically wide levels on both a relative and absolute basis. While these wider spreads partly account for a more hostile regulatory environment and elevated concerns on deal financing, these perceived risks have not materialized into deal failures. Notably, the Department of Justice, one of the two major anti-trust regulators in the US, lost two major court cases during September where they sought to block a merger. This sets a favourable precedent: that the FTC and DOJ, despite having an aggressive mandate to scrutinize merger deals, must follow anti-trust laws and be assured they can win their case in court.

SPAC Market Update

At the end of September, SPACs searching for targets were trading at a discount to trust, which provides a yield-to-maturity in excess of 6.8%³. With SPAC arbitrage effectively reflecting acquiring a treasury bill at a discount, SPACs currently provide a higher yield than US Corporate Investment Grade Bonds⁴ with lower credit risk, shorter duration and a tax advantage as SPAC returns are primarily capital gains.

The surge in SPAC yields has been relentless this year, and continued to reach new highs in September. With diminishing prospects of finding a target for a business combination to merge with, sentiment has worsened for SPACs creating a greater dispersion and breadth of SPAC arbitrage opportunities. The surge in SPAC yields is occurring just as we enter what we believe is the peak of the SPAC maturity cliff, where hundreds of SPACs that will likely be unable to find a target prior to maturity will be forced to liquidate and return capital to investors.

A clear sign of the turn in sentiment for SPACs was the announcement in late September by “SPAC King” Chamath Palihapitiya that two of his SPACs, including his largest, “IPOF” with over \$1.15B raised would wind down and return capital to investors⁵. In the filing announcing the closure, Palihapitiya stated “*Over the past two years, we evaluated more than 100 targets and while we came close to doing a deal several times, we ultimately walked away each time for a couple of reasons,*” indicating that valuations and volatility were key hurdles to close a deal. Zooming out, we can see the Social Capital founder was not alone in throwing in the towel. Over 20 additional SPACs were liquidated in Q3, and we expect many more liquidations to come. By all appearances, the SPAC boom has turned to bust, which means we expect a compelling opportunity for SPAC arbitrage over the next few quarters.

Portfolio Update

Returns in the Fund declined in September as the large sell-off in the market drove a widening of arbitrage spreads and selling pressure drove up liquidity premiums in many merger deals. This widening of spreads occurred within some of the Fund’s shorter duration holdings where we expect a closing to occur in a period of weeks, which should drive a

¹ This Pender performance data point is for Class F of the Pender Alternative Arbitrage Fund. Other classes are available. Fees and performance may differ in those other classes.

² <https://www.refinitiv.com/perspectives/market-insights/two-year-ma-boom-runs-out-of-steam/>

³ <https://spacinsider.com/stats/>

⁴ <https://fred.stlouisfed.org/series/BAMLCOA4CBBEY>

⁵ <https://www.bloomberg.com/news/articles/2022-09-20/palihapitiya-to-wind-down-two-spacs-after-failing-to-reach-deals>

subsequent tightening and eventual closing of those spreads. We took advantage of widening spreads to add to or initiate new positions in merger arbitrage deals that we believe have a higher probability of closing than implied by the market. We continue to focus on finding small and mid-cap merger arb opportunities and targeting deals with shorter durations. Given the surge in SPAC yields, which now in some cases exceed the potential yield of certain merger arb deals, we will look to increase our SPAC exposure by targeting investments that offer a yield in excess of 5.5% with a duration of under four months.

Last month we launched the Pender Alternative Arbitrage Plus Fund (PAAP), a leveraged version of the Fund. We believe that adding leverage to an arbitrage strategy may potentially enhance returns while still maintaining relatively low volatility compared to other alternative or traditional investment strategies.

While PAAF is focused on small and mid-cap merger deals, we will occasionally initiate a position in a large-cap merger deal, particularly when the deal has been de-risked but still trades at an attractive spread. One such holding was Citrix Systems, Inc., (NASDAQ: CTXS) which was the target of a large leverage buyout led by PE firm Vista Equity. This holding traded at a wide spread this summer amid financing uncertainty for the deal. Underwriters, who were committed to financing the deal, struggled to find buyers for the debt. Finally and after taking a reported \$700 million loss, the consortium of banks placed the debt in late September with the acquisition now closed. While this large loss may tighten lending in the LBO market in the short term, many existing LBO deals are trading at wide spread, which also reflects financing uncertainty. Moreover, the success of this deal provides added comfort that banks will meet their commitments.

The Fund initiated positions in seven new or previously announced merger deals in September, with eight deals closing during the month. At the end of September, the Fund had 28 investments in small-cap deals under \$2B, 19 of which were valued at under \$1B.

Outlook

Last month, the S&P 500 fell more than 9% to a two-year low, inflationary pressures mounted, geopolitical tensions continued to rise, and central banks' commentary grew increasingly hawkish, all quashing expectations for a soft landing. Suffice it to say, September was a miserable month for investors. This pain was not limited to equities; the Bloomberg U.S. Aggregate Bond Index fell 4.6% in September, the largest monthly decline since December 1981. Systemic risk appears elevated, and contagion fears are clearly on investors' minds. The latter is particularly true following the significant move in Gilts, which forced the BOE to bail out UK pension funds, in addition to the challenges and widening CDS spreads for Credit Suisse, which have raised fears of a Lehman-style crash. It appears that elevated volatility is here to stay for the foreseeable future and key central banks are not in a position to calm uncertainty, especially now that we expect the market to price in another mega 75bp increase at the November Fed meeting.

In this market environment, a non-correlated, event-driven investment strategy can be highly useful to investors, particularly given the downside protection potential as recession fears mount. That potential downside protection was exhibited in the Pender Alternative Arbitrage Fund this year, with the largest peak-to-trough decline in the Fund taking place from April 19, 2022 to June 16, 2022. The Fund declined 3.0% over that period, offering far better downside protection with the S&P 500 down over 17%, the SPTSX down over 13%, the Bloomberg US Corporate High Yield Bond Index down nearly 7% and the Bloomberg US Corporate Bond Index down nearly 3.3% over that same period. With low volatility, downside protection, the potential to generate absolute returns and providing hedge to rising interest rates, merger arbitrage is well positioned to add value to investors in this environment.

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PENDER
PenderFund Capital Management Ltd.

Standard Performance Information for the Pender Alternative Arbitrage Fund may be found here: <https://www.penderfund.com/pender-alternative-absolute-return-fund/>

The Pender Alternative Arbitrage Plus Fund was launched in September 2022. Standard Performance Information for this Fund will be available one year after inception.

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