PENDER
ALTERNATIVE ARBITRAGE FUND

MANAGER'S COMMENTARY – OCTOBER 2022

Highlights

- The Fund initiated a position in the Twitter acquisition by Elon Musk. While this deal was a relatively bumpy ride, it's also a great example of the contractual and legal strength of a definitive merger agreement.
- We believe we are now at the peak of the SPAC maturity cliff. Hundreds of SPACs, which were formed in late 2020 and early 2021, are reaching their expiry having been unsuccessful in finding a target, resulting in them having to liquidate and return capital to investors. With dozens of SPACs announcing liquidations each week, there is an incredible opportunity for SPAC arbitrage investors. Many SPACs announcing an early liquidation are trading at near double-digit yields.
- The Fund had positive performance in October driven by the closing of several Fund holdings and an overall tightening of arbitrage spreads. We were quite active during the month initiating positions in 16 new or previously announced merger deals and closing 18 merger deals held within the Fund.

Dear Unitholders,

The Pender Alternative Arbitrage Fund (PAAF) was up 1.4% in October, bringing year-to-date performance to 2.5% and one-year performance of 3.6%[1].

All Eyes on Musk
The merger arbitrage sector and broader financial industry have been consumed by the acquisition of Twitter, Inc. (NYSE: TWTR) by Elon Musk since the deal was announced in April. One of the largest acquisitions announced this year and the largest leverage buyout in history, this merger could be characterized as a wild ride as far as friendly merger agreements go. From the initial ownership stake being disclosed, to Elon Musk requesting to join the board, then declining to join the board, to him finally threatening to make a hostile offer if his acquisition proposal was not accepted, the merger certainly had a unique start. In July, Musk terminated the merger, grasping at straws as he tried to find an excuse to walk away he came up with a Material Adverse Effect clause due to a material misstatement in reported bot numbers. There was little merit to this argument and even if it was shown that the Twitter management team had misrepresented the level of bot activity, it is unlikely that this would have been a valid reason to terminate the merger. Still, when dealing with the richest person in the world who has a history of flouting the rules and avoiding regulatory repercussions, the merger was not regarded as a sure thing and traded at a wide spread relative to the $54.20 per share offer.

We initiated a position in this merger shortly before the deal was terminated on the expectation that Musk would walk and Twitter would sue to enforce the merger. With all the conditions of the deal satisfied, the courts and the legal precedent being on Twitter's side and the trial appearing to go in Twitter's favour, Musk threw in the towel and announced his intentions to proceed with the acquisition at the initial offer price. While this deal was a relatively bumpy ride, it is also a great example of the contractual and legal strength of a definitive merger agreement.

SPAC Market Update
At the end of October, SPACs searching for targets were trading at a discount to trust, which provides a yield-to-maturity in excess of 7.1%[2]. With SPAC arbitrage effectively reflecting acquiring a treasury bill at a discount, SPACs currently

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[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://spacinsider.com/stats/*

provide a higher yield than US Corporate Investment Grade Bonds[3] with lower credit risk, shorter duration and a tax advantage as SPAC returns are primarily capital gains.

We believe we are now at the peak of the SPAC maturity cliff, where hundreds of SPACs that were formed in late 2020 and early 2021 are reaching their expiry, having been unsuccessful in finding a target, which results in them having to liquidate and return capital to investors. Sponsors who spent millions in legal, banking and marketing fees to set up and raise capital for their SPACs will walk away with a loss that is estimated to be approximately $8 million on average, with the aggregate loss of sponsor investment projected to be in the billions[4]. An oversupply of SPACs competing for a small pool of viable deals, new SEC rules creating a barrier for certain deal types and a reversal in the public-to-private valuation gap have diminished the probability of many finding a target. The aggregate performance for successful de-SPACs is generally poor, and many of them are running out of cash or filing for bankruptcy. Investors will probably be highly skeptical of deals brought forward by those sponsors in the future.

A further tailwind to SPAC yields has been a provision in the Biden Administration's Inflation Reduction Act of 2022. The 1% excise or buyback tax in the Act, which will be imposed in 2023, applies to any US public company that repurchases or redeems its shares. As currently written, US-based SPACs liquidating and redeeming their units may be subject to the tax, leaving sponsors liable for payment. In the current market environment, where the majority of SPACs will be unlikely find a target, many sponsors, even with several months or quarters until maturity, are electing to liquidate early, in 2022, to avoid the potential tax obligation. Other SPACs are seeking to extend their maturities, which would give them more time to find a deal, though this is a process that must be voted upon by unitholders. Just as in the case of a business combination vote where SPAC investors can exercise a put redemption option and elect to receive their proportional share of NAV back, a maturity extension vote also provides this ability. Like an early liquidation, electing to redeem a SPAC seeking an extension shortens the duration to receiving the cash and increases the yield of an investment in a SPAC.

With dozens of SPACs announcing liquidations each week, there is an incredible opportunity for SPAC arbitrage investors. As the yield on a SPAC is driven by the discount to trust value and the duration to closing, an earlier liquidation or redemption shortens duration, thereby increasing yields. Many SPACs announcing an early liquidation are trading at near double-digit yields.

With the pace of liquidations accelerating, there will be fewer SPAC liquidation targets for reinvestment in the coming months. Our initial view on the SPAC arbitrage opportunity was that it was likely to be short-lived and transitory. With this acceleration, that short-lived period may become even shorter. We are taking advantage of the current opportunity in SPAC liquidation while preparing to focus on our merger arbitrage strategy in the months ahead.

"The challenging environment for equities and bonds contrasts with the attractive opportunity in arbitrage."

Portfolio Update

The Fund had positive performance in October, driven by the closing of several holdings and an overall tightening of arbitrage spreads. We were quite active during the month, initiating position in 16 new or previously announced merger deals, with 18 merger deals held within the Fund closing. While M&A activity has slowed from the historical peak levels of last year, there is still a high level of deal activity, with trillions of dollars in private equity firms and corporate balance sheets looking to be deployed. With surging SPAC arbitrage yields and accelerated early SPAC liquidations, SPAC arbitrage yields currently offer a higher yield but lower risk than many merger arbitrage deals. Given this dynamic of higher returns with less risk, we have significantly increased our SPAC arbitrage exposure, targeting yields in excess of 6%. We believe the current SPAC arbitrage yield environment will be temporary, but we will take advantage of it for as long as these returns are offered.

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[3] https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY

[4] https://www.bloomberg.com/news/articles/2022-11-04/spac-sponsors-that-piled-in-amid-boom-may-face-4-billion-tab

The Fund had a deal-break during the month with Verano Holdings Corp. (CNSX: VRNO) terminating its all-stock merger agreement with Goodness Growth Holdings, Inc. (CNSX: GDNS) on October 14, 2022. We exited our position upon the announcement of the termination, despite ongoing litigation efforts by both parties. This action around one of the Fund's higher risk deals limited the downside impact. Risk analysis is the most crucial part of our investment process, with our primary goal being to avoid merger deals that we believe have the potential to break. We also aim to minimize the potential for drawdown through careful management of position sizing for deals held by the Fund that do break.

At the end of October, the Fund had 29 investments in small-cap deals under $2 billion, 18 of which were valued at under $1 billion.

Outlook

Equity markets experienced broad gains in October, recovering from a challenging selloff last month. Despite rising rates, inflation remains elevated, with the Canadian Consumer Price Index decelerating slightly to 6.9% while the US Consumer Price Index jumped to 8.2%. The risk of central banks overcorrecting and taking terminal rates higher than market expectations could weigh further on market sentiment. A global slowdown and recession are currently viewed as high-probability outcomes. The challenging market environment for equities and bonds contrasts with the attractive opportunity in arbitrage, since merger arbitrage yields high on a relative and absolute basis and SPAC arbitrage yields have surged as they benefit from a wave of liquidations. In this market environment, we believe a non-correlated, event-driven investment strategy can be highly useful to investors, particularly given the downside protection potential as recession fears mount.

Amar Pandya, CFA
November 24, 2022

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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/

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