

PENDER

ALTERNATIVE ARBITRAGE FUND

MANAGER'S COMMENTARY – NOVEMBER 2022

Dear Unitholders,

The Pender Alternative Arbitrage Fund (PAAF) was up 0.3% in November, bringing year-to-date performance to 2.8% and one-year performance of 3.1%¹.

M&A Market Update

Global M&A activity totalled \$3.3 trillion through the first 11 months of 2022. This was the second highest deal total on record despite being down 36% from last year's historic peak². Deal activity in November increased slightly by 3% from last month to nearly \$214 billion of M&A deals announced globally. The technology sector continues to lead deal activity, accounting for nearly 21% of global M&A, with strong demand from private equity acquirers as tech company valuations have fallen to more attractive levels.

Deal activity remains robust in both Canada and the US, with favourable M&A tailwinds. November was an active month for private equity-backed acquisitions closing and saw many large leverage buyouts, including fund holdings Tenneco Inc. (NYSE: TEN) and Zendesk, Inc. (NYSE: ZEN). Higher interest rates, credit risk aversion, recessionary fears and steep losses on syndicated deal financing from mergers announced early in the year when interest rates were lower have made it more challenging to secure deal financing for buyouts. Yet, private equity firms have found creative ways to secure financing for deals including the direct lending market, with many non-bank private credit providers financing deals. Many PE acquirers are also utilizing secondary market leverage such as preferred equity, deferred payments, net asset loans and seller financing. Other PE firms are forgoing debt entirely, choosing to finance transactions with just cash on the expectation that they will be able to add leverage when credit market conditions improve. Seeing the strong commitment from financial acquirers to seek out targets, secure financing and close acquisitions despite a volatile market environment is an encouraging sign for merger arbitrage returns.

SPAC Market Update

The impact from a provision in the Biden Administration's Inflation Reduction Act discussed in [last month's commentary](#), which would see a 1% excise tax imposed on corporate stock buybacks and potentially SPAC liquidations, is causing significant ramifications in the SPAC sector. Sponsors of SPACs who are already millions in the red from the fees to set up, market and raise capital in their SPACs are choosing to liquidate early, before the end of the year to avoid being potentially liable for the excise tax next year. The impact to SPACs was likely an unintended consequence of the buyback tax, which was aimed at removing the tax favourability of returning capital to equity holders in a corporation, as opposed to reinvesting in the business or paying wages to employees. In the current market environment, it remains highly challenging for SPAC sponsors to find a merger target that unitholders will support and approve of. Sponsors are therefore no longer looking to risk a further loss and are choosing to throw in the towel and wind down.

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://thesource.iseq.com/thesource/getfile/index/060a3956-d94e-49af-8f77-bf595e3dff98>

³ <https://spacinsider.com/stats/>

⁴ <https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY>

In many ways, the current environment brings the SPAC cycle full circle. Driven by low interest rates, speculative investor sentiment and unprecedented fiscal stimulus, the SPAC bubble of 2020 saw hundreds of SPACs raise hundreds of billions of dollars in capital. SPACs were a key beneficiary in that environment, given the skewed asymmetric incentives for sponsors and the frenzy surrounding blank-check companies. The capital these SPACs could provide was welcomed by the large number of early-stage, cash-flow negative and concept based private businesses willing to go public for a big payoff at a premium valuation. It seemed like every day a new SPAC deal was announced. Sponsors were anywhere from leading investment figures, private equity firms and asset managers, to celebrities, professional athletes, savvy opportunists and less savvy grifters. Nearly two years later, the bubble has burst, with SPACs that are coming up to their two-year maturity date having to liquidate and return capital to shareholders. To avoid being liable for the buyback tax, sponsors are choosing to liquidate early by year-end and in sharp contrast to those peak bubble weeks in 2020, nearly every day sees a SPAC sponsor announcing its intention to close down and liquidate their SPAC early.

The current opportunity for SPAC arbitrage is highly compelling for investors as we are currently lapping the peak of the SPAC bubble, which occurred starting in the spring of 2020 through the first quarter of 2021, by the typical two-year lifespan of a SPAC. As these SPACs come to maturity, many are liquidating or seeking to extend their maturity date, which requires them to offer investors the option to redeem. The significant supply of SPACs maturing this year, in addition to SPACs scheduled to mature next year but electing to liquidate early, is driving up yields. The yield of a SPAC arbitrage investment is driven by the trust value of the SPAC, the discount the SPAC trades to that value and the duration until closing. With the capital held in trust typically invested in treasury bills, higher interest rates have increased the trust value investors will receive, while early liquidations are shortening duration and increasing the IRR of an investment in a SPAC.

At the end of November, 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 (SPAC returns are primarily capital gains).

Portfolio Update

The Fund had positive performance in November, driven by the closing of several merger deals and an increase in value for many SPACs held in the Fund. This group of SPACs have announced early liquidation or redemption, with several indicating the NAV value investors would be receiving was higher than expectations. The month was very active on both the merger arbitrage and SPAC arbitrage side. The Fund's SPAC exposure increased significantly in the month as we positioned our holdings to benefit from the higher yields and shorter durations available with a wave of early SPAC liquidation and redemption options. The Fund also initiated positions in 7 new or previously announced merger deals with 11 merger deals held within the Fund closing.

Given surging SPAC arbitrage yields and a wave of early SPAC liquidations and redemptions, we continue to increase SPAC exposure in the Fund. SPAC arbitrage currently provides a potential superior investment opportunity to investment grade and even high-yield credit. In many cases, current SPAC arbitrage opportunities provide a superior yield to a large subset of merger arbitrage returns with lower risk. We believe the current SPAC opportunity will be short lived and transitory, but we will take advantage of it for as long as these compelling returns are offered.

The Fund's primary focus on risk analysis where we continually monitor, reassess, and optimize position sizing for deal-risk was demonstrated this month by the early exit of a higher risk deal and the avoidance of a deal-break and drawdown in the Fund. PAAF had previously initiated a small position in specialty materials company Rogers Corporation (NYSE: ROG), which had a definitive agreement in place to be

acquired by DuPont de Nemours, Inc. (NYSE: DD). The deal, which was announced in November 2021, had most of the required approvals and consents in place as of this summer and was awaiting Chinese regulatory approval to close. A key part of the investment process for the Fund is reacting to new information and reassessing deal risk for each holding. During the summer, it started to appear that final approval was unlikely to be received prior to the deal termination deadline of November 1, 2022. Our view was that Dupont was unlikely to extend the deal past the deadline as the valuation of the acquisition offer for Rogers was well above its current intrinsic value. We stopped adding to our position this summer, started to cut our weighting in September to de-risk our exposure and fully exited the position in October. On November 1, 2022 Dupont announced it would be terminating the acquisition with Rogers and paying a termination fee of \$162.5 million in accordance with the agreement. Rogers shares declined 44% the day after the termination was announced and had fallen by over 50% as of the end of November. Risk analysis is the most crucial part of the investment process for the Fund, with the primary goal of avoiding investing in merger deals that we believe have the potential to break.

At the end of November, the Fund had 20 investments in small-cap deals under \$2 billion, 11 of which were valued at under \$1 billion.

2023 Outlook

SPAC arbitrage remains a compelling opportunity for the Fund today, but we do not expect the opportunity to remain as attractive during 2023. The vast majority of SPACs launched during the bubble of 2020/2021 should mature in the coming months and, given the slower pace of SPAC IPOs, the SPAC sector should be far more balanced in the new year. With fewer SPACs in the market and arbitrage investors looking to reinvest capital from maturing SPACs, yields are likely to move lower. The size of the entire SPAC sector will also be a fraction of its multi-hundred-billion-dollar peak. This may present a challenge for SPAC-focused funds or arbitrage funds that have been highly reliant on SPACs for investment returns. Given this dynamic, we expect our SPAC exposure will decline, with the Fund turning our focus to our core competency in small and mid-cap merger arbitrage deals.

Despite increased volatility, higher interest rates and recessionary fears, we believe there are favourable tailwinds to drive elevated M&A activity in 2023. Secular trends that drove M&A during the pandemic, such as technology-driven disruption and reshoring of supply chains, remain a key issue for management teams and boards. Companies require new capabilities to compete and service their customers and clients and if those capabilities can't be developed internally, many are looking to acquire them externally. As technology valuations have reset, many tech businesses are trading at large discounts to conservative estimates of intrinsic value. The strong demand for technology acquisitions by both strategic and financial buyers seen in the past two years is likely to persist. The clean energy transition occurring across the globe is also driving M&A activity, with the energy and power sector experiencing the second highest level of deal activity after the tech sector this year. Rising rates may also put businesses in distress, which would create more prospects for opportunistic and value-oriented acquirers.

With trillions of dollars in private equity and public company coffers, there is ample capital on the sidelines for acquisitions. Private equity sponsors typically do not earn performance fees until capital is deployed so there are clear and direct incentives for them to put capital to work and complete acquisitions. The resilience and high success rate of LBOs and private equity backed deals this year is a promising sign that more PE backed deals should be expected next year. Public companies with disciplined M&A strategies that have proven to create value through acquisition are also well positioned to take advantage of dislocated and distressed acquisition opportunities in the market.

The 1% buyback tax in the US could also shift incentives and drive an increase in M&A activity. Corporations have limited options to deploy excess cash: debt repayment, organic investment

opportunities, acquisitions and capital return to shareholders. With capital return penalized in the form of dividend taxes and now a buyback tax, there is a small but potentially meaningful shift in the analysis of how a company should deploy cash, with M&A potentially becoming a superior use of excess cash.

Even if M&A activity should decline next year, we expect a robust environment to remain in our core focus of small and mid-cap merger deals. We are seeing signs of catalysts forming in many of the companies owned and followed by Pender's equity funds. Pender's own [history of investing in catalysts](#) has demonstrated that certain types of small and mid-cap businesses are take-out candidates across the market cycle.

Market conditions remain challenging for investors to navigate, with the rate hike cycle showing signs of slowing but not stopping as inflation remains elevated and labour markets remain tight. Given this uncertainty, investors could consider adding exposure to non-correlated alternative strategies that can deliver absolute returns in any market environment. We believe that SPAC arbitrage yields currently provide a superior opportunity from both a return and risk perspective, relative to investment grade bonds. Merger arbitrage spreads are wide on both a relative and absolute basis, making them a compelling alternative to bonds with a tax efficient return that has historically proven to be an effective interest rate hedge. After a challenging year in traditional assets, alternative investment strategies like risk arbitrage have demonstrated their value and earned a place in investors' portfolios.

We would like to thank our clients and investors for their support and look forward to serving you in 2023. Happy Holidays to you and your families and all the best in the New Year!

Amar Pandya, CFA
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PenderFund Capital Management Ltd.

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