

MANAGER'S COMMENTARY – JANUARY 2023

Dear Unitholders,

The Pender Alternative Arbitrage Fund was down 0.1% in January¹.

M&A Market Update

Global M&A activity kicked off 2023 with roughly \$122 billion of deal activity through January; a large decline relative to the \$385 billion of deal value at this point last year². While deal activity declined across most regions globally, including the US, Canada was one of the few bright spots where M&A activity increased year-over-year. From a sector perspective, the industrial sector was the most resilient, seeing some large deals materialize during the month. It is difficult to draw a definitive trend from the first month of the year, but clearly higher interest rates, greater risk adversity from lenders and rising recessionary fears are keeping some buyers on the sidelines. However, in our core small and mid-cap company focus, we see encouraging signs that M&A activity is poised to increase. This is driven by the trillions of dollars of cash on corporate balance sheets and private equity coffers, as well as the significant discount between market value and private or intrinsic value. With the valuation gap between private and public companies remaining at wide levels, buyout activity is likely to remain elevated, providing a favourable tailwind through the year.

SPAC Market Update

At the end of January, SPACs searching for targets were trading at a discount to trust, which provided a yield-to-maturity of 7.0%³. With SPAC arbitrage effectively equating to 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.

After the wave of SPAC liquidations in December and despite the SPAC sector halving in size through 2022, there still remain over 500 active SPACs in the market today, with roughly 360 of them actively seeking targets⁵. The pressure remains high on sponsors to find and close a deal. Approximately 350 SPACs, with nearly \$100 billion in assets, are facing maturity in 2023. Many SPACs with maturities coming up in the short term are seeking an extension, which requires shareholder approval, typically with the sponsor making an extension payment that increases the value held in trust for all unitholders. We typically vote against extensions and have always elected to redeem our units for trust value as opposed to continuing to hold a SPAC past its maturity. This is what the majority of SPAC holders have also done in recent months, which has forced these SPACs to return the majority of capital raised. This has left a pool of post-redemption SPACs, a fraction of their former size, with small floats, delisting risk and a recently extended, but still contracting, timeline to find a target to merge with. As these post-redeemed SPACs have all the same restrictions and obligations of their former selves, they may present an opportunity down the road as they approach their new maturity dates. This is yet another investment opportunity in this post-SPAC bubble environment.

SPACs searching for targets have started to adjust to a new environment and focus on smaller deals. Many of the SPAC mergers announced in January had a value of around \$200 million, a tenth of the

¹This 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.

²Refinitiv Investment Banking Scorecard – Deal Intelligence I as February 2, 2023

³<https://spacinsider.com/stats/>

⁴<https://fred.stlouisfed.org/series/BAMLC0A4CBBEY>

⁵<https://www.spacresearch.com/>

average \$2 billion SPAC merger announced in 2021 during the peak of the bubble⁶. For smaller private businesses desperate for cash while finding it difficult or too costly to raise capital in the private markets, a merger with a SPAC can be a compelling proposition. For the Fund, our focus since inception has been buying SPACs at a discount to the value held in trust and then receiving that value upon redemption or liquidation of the SPAC. Should a SPAC we hold announce a proposed business combination with a target company, we would elect to redeem our SPAC units for the trust value, shortening our duration of investment as opposed to having to hold until maturity.

Portfolio Update

After a busy December where we had positioned the Fund to take advantage of the wave of year-end SPAC liquidations, January was an active month as we redeployed proceeds from those liquidations into new deals. The Fund initiated positions in 12 new or previously announced merger deals, with eight merger deals held within the Fund closing. Arbitrage spreads narrowed during the month as capital from SPAC liquidations and recently closed arbitrage deals was deployed into live deals. Despite the narrowing, spreads still remain wider than historical levels on an absolute and relative basis. There wasn't much progress on merger deals held in the Fund during the month, which typically drives the narrowing of spreads until closing. A small number of deals in the Fund also saw their estimated closing dates pushed out from weeks to months as there were delays in receiving their final approvals. Year-end is the cause of some of these delays as many companies go into blackout periods in January, and the lawyers, auditors and accountants who need to provide approvals are also focused on year-end results. We therefore expect to see a pickup in deal closings in the coming weeks after Q4 results have been announced.

The regulatory environment remains challenging for Big Tech acquirers and large-cap merger deals particularly given the DOJ and FTC increasing regulatory scrutiny and challenging several proposed mergers. With higher regulatory risk, increased duration risk and an uncertain and unpredictable approval process for larger cap stocks, the Fund's positioning and primary focus on small and mid-cap merger deals should be a relative advantage. Smaller mergers are less likely to breach a concentration or competition threshold, and these mergers typically don't face significant regulatory risk and can close in a shorter period of time, thus decreasing the duration and increasing the IRR of an investment in the merger.

At the end of January, the Fund had 27 investments in small-cap deals under \$2 billion, 19 of which were valued at under \$1 billion. As mentioned in [last month's commentary](#), we have seen a spike in M&A activity within our universe of small and mid-cap companies, which were either current holdings in our equity funds or on our watchlists. These are ideal candidates for the Fund because we can leverage our existing research, insights and estimates of private market value to determine the probability of the acquisition offer being accepted and the expected duration until the merger closes. Magnet Forensics Inc. (TSX: MAGT) was the latest Pender equity take-out that was initiated in the Fund. We initially purchased Magnet at the company's IPO in April 2021 in one of Pender's equity funds. As management executed on its strategy, the share price climbed to more than double its IPO price and on January 20, 2023, the company announced an acquisition offer from private equity firm Thoma Bravo for proceeds of \$44.25 per subordinated share. As a key holding in our equity funds, we were able to leverage our existing insights and estimates of private market value for the business and quickly initiate a position in the deal. We see favourable tailwinds within our universe suggesting a strong M&A outlook this year, which should benefit the Fund.

⁶ <https://www.wsj.com/articles/spac-deals-shrink-after-speculation-wanes-11674185893>

Outlook

The market environment remains uncertain, with growing recessionary fears, rising interest rates and higher-than-target inflation (recent disinflation trends are not expected to lead to deflation). Equity markets posted a strong recovery in January as the pressure of tax-loss selling faded and technical factors, including short covering, drove a rebound in some hard-hit sectors of the market. With the job market looking tight in both Canada and the US and despite the pause in rate hikes discussed by the BOC (after it had raised rates a further 25bp during the month), the path for future rates remains uncertain. The non-correlation, interest-rate hedging and low volatility benefits of an alternative strategy like merger arbitrage can provide needed diversification to investors in an environment such as this.

SPAC arbitrage yields, which declined at the start of the month, had widened out by month-end with a pickup in extension votes and deal activity. Our positioning remains focused on SPAC liquidations that provide an attractive low-risk yield and tax-efficient returns relative to bonds. As more SPACs liquidate and the sector moves towards an equilibrium, we believe there may be an opportunity to invest in a limited number of SPAC IPOs should the terms be favourable. That said, our core focus and positioning in the Fund remains targeted on merger arbitrage investments.

We see a favourable opportunity in merger arbitrage markets today given the increased level of M&A activity in the Fund's areas of focus on small and mid-cap merger deals and particularly in the core universe where Pender's equity funds already invest. There are favourable tailwinds that give us confidence that deal activity could increase in our universe, including: the wide disconnect between market and intrinsic value, rising frustration amongst shareholders of target businesses, a spike in activist campaigns and strategic reviews and the incentives and ample financial capacity of acquirers.

*Amar Pandya, CFA
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PenderFund Capital Management Ltd.

All dollar figures are in USD unless otherwise indicated.

Standard Performance Information for the Pender Alternative Arbitrage Fund may be found here:

<https://www.penderfund.com/pender-alternative-arbitrage-fund/>

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