PENDER
ALTERNATIVE ARBITRAGE FUND

June 2023

Manager’s Commentary

Amar Pandya

Highlights

- June was a good month for the Fund as it harvested returns from several closed merger deals, which we added to at wider spreads in May.
- The Fund took advantage of recent volatility to bring net exposure to nearly 100%, the highest level this year.
- The Fund initiated positions in seven new or previously announced mergers; 10 merger deals in the Fund closed during June.

Dear Unitholders,

The Pender Alternative Arbitrage Fund was up 0.7%[1] in June 2023.

M&A Market Update

Worldwide M&A activity totalled $1.3 trillion through the first half of 2023, down 37% from the same period last year[2]. Global M&A has declined this year as economic uncertainty, persistent inflation, higher interest rates, increased regulatory scrutiny and a precarious geopolitical environment have impacted the ability to complete deals. While these factors continue to weigh on markets today, the second quarter of the year did see a material improvement in deal activity with a 33% increase in total deal value from the first quarter of the year. Better-than-expected equity market performance, disinflation trends materializing and improved perceived visibility in the path of interest rates all appear to have given acquirers greater confidence to make deals.

The healthcare and energy & power sectors have led deal activity this year, surpassing the technology sector, which has led activity since 2020. While the share of private equity-backed mergers has declined from peak levels over the past two years when PE-led deals represented nearly half of all activity, PE-led activity in the first half of 2023 still ranks as the fourth highest level on record. With ample dry powder to deploy and strong financial incentives to do deals, we expect PE to remain active in public markets through the second half of the year.

With a hostile regulatory environment targeted at mega merger deals, large-cap M&A has seen a steep decline this year. Through the first half of 2023, there have been only 14 deals greater than $10 billion in size, a 53% decline from the same period last year and the lowest period of mega deal M&A since 2017. Large-cap M&A is likely to remain under pressure this year with key regulators at the FTC and DOJ continuing to demonstrate hostile regulatory oversight and increased anti-trust scrutiny. As larger deals continue to face regulatory and financing challenges, small merger deal activity should benefit, since they are relatively

[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.*
[2]Source: Refinitiv Investment Banking Scorecard – Deal Intelligence I as of July 1, 2023

lower risk and easier to finance in a capital-constrained environment. With large-cap M&A typically being more transformational in nature, which is a challenging strategic decision in an uncertain environment, smaller deals in the form of tuck-ins for synergies or acquisitions to add new capabilities or expand into new markets are likely to be viewed as lower risk to investors. This will make it easier for management teams and boards to convince shareholders, bankers and debtholders of the merits of doing the deal.

"Our focus remains on small- and mid-cap merger deals positioned to benefit from wider spreads and not subject to the same deal and duration risk as large-cap mergers."

SPAC Market Update

The SPAC sector continues to shrink as SPACs approach their maturity date and are redeemed or liquidated for trust value. Sixteen SPACs liquidated in June, return $4.4 billion to unitholders. The amount of capital held in trust by SPACs also continues its decline, dropping by nearly $10 billion from May to under $40 billion at the end of June. There is likely to be a further curtailing of the SPAC market before an equilibrium is reached whereby SPAC spreads widen and only the best-in-class sponsors who can provide a compelling investment proposition for investors remain. The slow pace of activity for new SPAC IPOs is aiding the shift towards a sustainable equilibrium with only 17 IPOs to date raising under $2 billion. This year-to-date figure of new issuance for the entire SPAC sector is less than half the capital that was raised by a single SPAC in 2020, (Bill Ackman's Pershing Square Tontine Holdings Ltd). This highlights how much has changed for SPACs from the zenith of the SPAC bubble in 2020-2021.

At the end of June, there were just under 391 active SPACs in the market with assets over $38 billion, 222 of which were searching for targets. As the SPAC sector shrinks, so has the SPAC exposure in the Fund, with our focus on acquiring SPACs at a discount to trust value offering an attractive yield through redemption or liquidation. At the end of June, SPACs searching for targets were trading at a discount to trust value, which provided a yield-to-maturity of 5.5%. With SPAC arbitrage effectively equating to acquiring a Treasury Bill at a discount, SPACs currently provide an almost-similar yield to US Corporate Investment Grade Bonds with lower credit risk, shorter duration and a tax advantage, since SPAC returns are primarily capital gains.

Portfolio Update

June was a good month for the Fund as it harvested returns from several closed merger deals which we added to at wider spreads in May. The Fund was well positioned going into June after a more volatile May, which saw spreads spike across the arb space thanks to deal terminations and continued regulatory hostility from the FTC. We took advantage of that volatility by initiating or increasing our exposure in several deals where we believed risk was mispriced and brought up the net exposure in the PAAF to nearly 100%, the highest level this year. Spreads continued to widen through June, which provided opportunities to redeploy capital from closed deals with a healthy flow of high-quality small and mid-cap merger deals. After a challenging year for the merger arbitrage sector, investors appear to have reacted to a more hostile regulatory environment demanding greater compensation to take on deal and duration risk, which has driven up yields for merger arb deals.

Through the month of June, the Fund initiated positions in seven new or previously announced mergers and 10 merger deals held within the Fund closed during the month. Heska Corporation (Nasdaq: HSKA), Ruth's Hospitality Group Inc (NASDAQ: RUTH), Momentive Global Inc. (NASDAQ: MNTV), Kimball International, Inc. (NASDAQ: KBAL) and Ranger Oil Corporation (NASDAQ: ROCC) were among the small-cap deals held in the Fund that closed during June. We continue to see a high dispersion in spreads, particularly for smaller merger deals and deals with elevated regulatory risk. Our focus remains on small and mid-cap merger deals that are positioned to benefit from wider spreads while not being subject to the same deal and duration risk as large-cap mergers. At the end of June, the Fund had 22 investments in small-cap deals under $2 billion, 18 of which were valued at under $1 billion.

One of the new deals purchased in the Fund in June was Circor International Inc. (NYSE: CIR) an industrial manufacturer of flow and motion control parts for the aerospace and defence sector. The company entered into a definitive agreement to be acquired by investment company KKR & Co Inc (NYSE: KKR) for $49/share on June 5, 2023. We assessed this deal as high quality with a very strong well-financed bidder, low regulatory risk, and an attractive yield. Another bidder, private equity firm Arcline Investment Management, which owns a competitor of Circor, emerged in the weeks following the offer, which led KRR to revise its offer to $51/share on June 27, 2023. This led to a counteroffer from Arcline followed by a top-up bid from KRR, which improved its offer to $56/share with the potential for a further $1/share should the deal take longer to close. The board accepted this offer, which was at nearly a 15% premium to the initial deal price. A higher revised offer in an all-cash merger deal can be a large source of returns for arbitrage investors. This is more typical in smaller deals where multiple bidders can emerge, synergies are higher or more realizable as in the case of a tuck-in acquisition and there is a greater likelihood of mispricing.

Outlook

One of the key benefits of a merger arbitrage strategy is the short duration of investments, which allows market participants to react quickly to new information and new market dynamics and reprice risk accordingly. With the first half of 2023 exhibiting a more challenging environment for the merger arb industry, which was fraught with an unprecedented hostile regulatory regime, the industry has reacted to higher interest rates, lower deal activity and elevated regulatory risk, resulting in a favourable yield environment on both a relative and absolute basis.

Deal activity remains low despite a pickup in activity in Q2, but there are promising signs that activity could increase in the back half of the year. Corporate balance sheets and PE coffers remain flush with capital looking to be deployed and technological disruption could accelerate with the rapid growth of artificial intelligence forcing companies to acquire capabilities and expertise in order to remain viable. The surprising strength in equity markets has been driven by large-cap companies, which have expanded the gap between small and large cap valuations to near-record levels and created opportunities for accretive acquisitions for large companies or financial acquirers. While higher interest rates can be a headwind for large M&A deals as the cost and availability of financing is more challenging, it also can put pressure on businesses and make an acquisition below intrinsic value more tolerable for target company shareholders. As investor activism continues to rise and more companies look for ways to realize or unlock value, M&A activity in the small and mid-cap space is primed for action.

While inflation in both Canada and the US is showing continued signs of easing, labour markets remain strong and consumers continue to tap into residual savings from the pandemic putting pressure on the prices of goods and services. Commentaries from both central banks suggest that rates could remain high for longer than expected and that further rate hikes are possible should inflation rise. Despite rising rates, growing concerns about the economy and cracks forming in certain markets, the US equity market continues to exhibit confounding strength. This market environment presents a conundrum for investors — there is uncertainty in the path of interest rates as signs of a slowdown materialize, yet inflation remains high and persistent. As large-cap and broad equity market index valuations have expanded considerably through the year with equity risk premiums shrinking, investors are left with the challenging decision of where and how to allocate capital in an investment portfolio. With the path of interest rates and equity markets difficult to predict, investors would benefit from adding exposure to non-correlated, event-driven alternative investment strategies like merger arbitrage to hedge unpredictable and volatile market conditions.

Amar Pandya
July 20, 2023