Manager's Commentary

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Highlights:

- July was an active month for the Fund as we continued to harvest returns from closed merger deals and reinvest that capital in new mergers.
- Merger arbitrage spreads continued to remain at wide levels in July following an expansion of spreads in June with some key catalysts on larger merger deals resulting in a narrowing of spreads throughout the month
- Activism activity remains elevated within our universe with frustrated shareholders increasingly demanding that boards take action to close the gap between intrinsic and market valuations.

Dear Unitholders,

The Pender Alternative Arbitrage Fund was up 0.3%[1] in July 2023.

M&A Market Update

Worldwide M&A activity totaled $1.7 trillion through the first seven months of 2023, down 28% from the same period last year[2]. While macro factors including persistent inflation, still rising interest rates, economic uncertainty and geopolitical tension continue to be a hindrance for M&A, there are also encouraging signs of stabilization and enough visibility to bring buyers and sellers to the table. Disruptive technologies from clean energy, EV's, AI and superconductors are leading to transformational opportunities with a catalyst for companies to acquire new capabilities in order to compete in a rapidity changing world. While most regions around the world have seen M&A activity decline, Canada remains one of the few regions globally where M&A activity is up this year, driven by activity in the mining & metals and oil & gas sectors as well as mega private merger deals like the acquisitions of HSBC Bank Canada and Viterra. Private equity and other financial buyers remain well capitalized and incentivized to make acquisitions despite higher financing costs and tighter lending conditions. One company bucking the trend and leaning into the opportunity is Brookfield Asset Management which announced roughly $50 billion of acquisitions in the first half of the year making it the most acquisitive investment firm this year with ambitions to raise a $150 billion of capital for further investments by year end[3]. In a higher rate environment, businesses with deflationary benefits, like technology companies, as well as those poised to benefit from higher inflation, like infrastructure companies, can both be highly attractive targets for acquirers.

One industry that could see an unexpected rise in M&A activity emerge later in the year is the US banking sector. The US regional bank crisis this spring which resulted in the failure of three banks continues to weigh on the industry with stock prices depressed, fleeing deposit during the crisis not returning and rising interest rates resulting in trillions in paper losses[4]. With these ongoing issues and burdensome regulatory costs and investments in technology required, consolidation is on the minds of management and boards. With more than 4,000 US regional banks, regulators have been signaling

[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 August 3, 2023*

[3] https://www.bloomberg.com/news/articles/2023-08-09/brookfield-defies-deal-gloom-projects-record-inflows-in-2023

[4] https://www.wsj.com/articles/bank-deals-are-back-on-the-table-getting-one-done-could-be-messy-3d77a2b2

that they are supportive of consolidation, which should be welcomed by investors. July saw the first signs of this consolidation wave with the announcements of two bank mergers, the acquisition of American National Bankshares Inc. by Atlantic Union Bankshares Corp. and the acquisition of PacWest Bancorp. by Banc of California Inc. We have historically limited our exposure to bank mergers in the Fund given the burdensome regulatory approval process which can lead to a long duration to closing and elevated deal extension risk. With regulators indicating they are open to more bank mergers, the banking sector might be one of the only industries with a favourable regulatory tailwind improving the appetite for investment in future bank deals.

As we have discussed throughout the year, a key development weighting on M&A activity this year has been the unprecedented hostility from US regulators targeted at large cap merger deals. While there have been a few recent large cap merger victories against regulators, the regulators have come out swinging with the release of new draft merger guidelines earlier this month. These new guidelines from the Federal Trade Commission (FTC) and Department of Justice (DOJ) aim to "better reflect how the agencies determine a merger's effect on competition in the modern economy and evaluate proposed mergers under the law[5]." The draft guidelines have been structured around 13 principles that provide a new framework that regulators will use to determine if a merger violates antitrust laws. This is a heavily reformative framework with the stated goal of substantially lowering the threshold at which a merger is presumed to be anticompetitive and can be challenged while also providing regulators with the ability to challenge deals using novel or less proven legal theories. The ultimate outcome from these guidelines is likely to be a further headwind for large merger deals and increased politicization of the merger review process. While the repercussions from these merger guidelines, if implemented as currently written, will be a hinderance to overall M&A, small and mid-cap merger deals, which are the primary focus for the Fund, are likely to be unaffected. We could even see activity rise as greater regulatory scrutiny on the dominant market leader allows for a more level playing field against other competitors.

SPAC Market Update

The SPAC sector continues to shrink as SPACs approach their maturity date and are redeemed or liquidated for trust value with 16 SPACs liquidated in July, returning $3.4 billion to unitholders[6]. With only four SPAC IPOS during the month raising less than $1 billion the total amount of capital held in trust by SPACs at the end of July has fallen to roughly $34 billion. As hundreds of SPACs faced their maturities this year and given the poor prospects of finding a target to merge with, many SPACs have chosen to seek a SPAC extension rather than throwing in the towel and liquidating. Some sponsors have chosen to kick the can down the road by seeking to extend the time they have to find a target rather than crystalizing the losses from launching a SPAC that has failed to merge with a target. This requires a vote and, depending on the extension terms, it typically requires the deposit of additional cash into the trust account by the sponsor as well as a partial transfer of the sponsors coveted founder shares. A feature of a SPAC is the put redemption option held by unitholders, so in the event that a SPAC seeks to liquidate or extend we are indifferent, as long as it trades at a discount sufficient to provide an attractive yield as we elect our redemption rights and receive our proportionate claim on the assets held in trust. A benefit of a SPAC successfully achieving an extension is that it typically increases the maturity date but only by a few quarters, providing us with another potential opportunity in the not-too-distant-future to harvest further SPAC arbitrage gains.

At the end of July, there were 372 active SPACs in the market with assets under $34 billion, 206 of which were searching for targets. As the SPAC sector shrinks, so has the SPAC exposure in our Fund, with our focus on acquiring SPACs at a discount to trust value offering an attractive yield through redemption or liquidation. With SPAC arbitrage effectively equivalent to acquiring a Treasury Bill at a

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[5] https://www.justice.gov/opa/pr/justice-department-and-ftc-seek-comment-draft-merger-guidelines

[6] https://www.spacresearch.com/

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discount, SPACs currently provide an almost-similar yield to US corporate investment grade bonds with lower credit risk, shorter duration and a tax advantage, as SPAC returns are primarily capital gains.

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Portfolio Update

July was an active month for the Fund as we continued to harvest returns from closed merger deals and reinvest that capital in new mergers. Through the month of July, the Fund initiated positions in 17 new or previously announced mergers. Nine merger deals held within the Fund closed during the month. Merger arbitrage spreads continued to remain at wide levels in July following an expansion of spreads in June with some key catalysts on larger merger deals resulting in a narrowing of spreads throughout the month. SPAC exposure, which had declined to nearly 10% in June, increased throughout the month of July as dozens of SPACs announced liquidations or extensions, providing an opportunity to acquire SPAC at a discount to their trust value and capture those spreads. We continue to position the Fund in small and mid-cap merger deals and we seek to take advantage of the higher spread environment while avoiding the deal risk and duration risk, which has been elevated for larger deals throughout the year.

US regulators continue to challenge large cap merger deals and are seeking more ammunition with the new draft merger guidelines discussed previously. If implemented as currently written, the new guidelines will likely be a deterrent for large-cap M&A, and "Big Tech" and "Big Pharma" will be key targets for the regulators. Despite the ambitions and ideology of regulators wanting to slow or stop M&A, the letter of the law still matters and regulators need to win in court when challenging a merger deal. July demonstrated this dynamic with a string of victories for the market against regulators. The FTC, who have been seeking to block Microsoft Corporation's (NASDAQ: MSFT) proposed acquisition of Activision Blizzard, Inc. (NASDAQ: ATVI), were denied a preliminary injunction request by a court in California and subsequently denied their motion for injunctive relief which sought to delay the closing of the merger until an appeal is complete. The Fund's holding of Black Knight Inc. (NYSE: BKI), which is being acquired by Intercontinental Exchange, Inc. (NYSE: ICE), also announced an agreement to divest a business segment where regulators were concerned about market concentration which is expected to lead to a dismissal of the FTC's federal court complaint and paves the way for the merger to be completed. With each challenge costing the regulators time and money, these losses set a precedent and limit the probability of future challenges while acting as a restraint against overzealous regulators.

While the changing dynamics of the regulatory environment are topical and likely to have an impact on total M&A, our focus remains on small and mid-cap merger deals which remain sheltered from much of these new regulatory dynamics. The ideal merger deal for the Fund is when a small-cap company that is a current or previous holding in our equity funds gets acquired. This allows us to leverage our insights, research and trading expertise in the security and take advantage of market inefficiencies which are prevalent for small cap stocks. The acquisition of Dialogue Health Technologies Inc. (TSX: CARE) by Sun Life Financial Inc. (TSX: SLF) and Quotient Technology Inc. (NYSE: QUOT) which are recent additions to the Fund are examples of those high-quality small-cap merger deals in our sweet spot, with both companies being previous holdings in our equity funds. At the end of July 2023, the Fund had 27 investments in small-cap deals under $2 billion, 20 of which were valued at under $1 billion.

Standard Performance Information for the fund may be found here: www.penderfund.com/pender-alternative-arbitrage-fund
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Outlook

The second quarter of the year has seen a sequential improvement in M&A activity which appears to have continued through the start of the third, particularly for small and mid-cap companies which are the target universe for the Fund. While higher interest rates and uncertain market conditions have weighted on M&A activity this year, the spread between small and large cap company valuations has widened to historical levels creating an attractive opportunity for acquirers to take advantage of dislocated valuations amongst smaller companies. Activism activity remains elevated within our universe with frustrated shareholders increasingly demanding that boards take action to close the gap between intrinsic and market valuations. Smaller merger deals and private equity buyouts with low anti-trust and competitive risk are ideal opportunities in the current environment. We see favourable conditions for merger activity within our core universe to increase as buyers and sellers are motivated and incentivized to come to an agreement.

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