PENDER
ALTERNATIVE ARBITRAGE FUND

December 2023

Manager's Commentary

Amar Pandya, CFA

Dear Unitholders,

The Pender Alternative Arbitrage Fund was up 0.9%[1] in December 2023 and 1.3% for the full year ended 2023.

M&A Market Update

Global M&A plunged to decade low in 2023 with $2.9 trillion in deal value announced, a 17% decline from last year.[2] Activity was subdued through most of the year as dealmakers grappled with higher inflation, rising interest rates, increased regulatory scrutiny and market uncertainty. Private equity buyers saw a notable decline in activity this year after accounting for nearly a quarter of all buyouts in the previous two years as tighter financing conditions and higher interest rates weighed on the ability to complete leverage buyouts. Commodity and industrial sector companies saw a big pickup in activity as inflation benefited many of these businesses and companies looked to scale their operations to drive improved efficiencies. The energy sector led M&A activity with several mega merger deals announced in the back half of the year with deal activity in the US Permian shale region surpassing $100 billion. While technology sector M&A declined in 2023 by both deal volume and deal value, two of the largest merger deals of the year, Activision Blizzard Inc's $69 billion acquisitions by Microsoft Corp (NASDAQ: MSFT) and VMware, Inc's $61 billion acquisition by Broadcom Inc (NASDAQ: AVGO) closed successfully and the sector continues to see strategic and financial deals being struck. The healthcare sector also saw a significant pickup in activity with dozens of biotech and pharmaceutical merger deals announced as the industry's largest drugmakers face a steep patent cliff over the next decade and are actively seeking to refresh and extend their patent drug portfolios. Overall 2023 was a challenging year for M&A and merger arbitrage with various headwinds impacting deal activity and deal closings, but with a notable pickup in activity in the fourth quarter there are many reasons to be optimistic on the M&A outlook for 2024.

Dealmakers adapted to a more challenging environment for M&A in 2023 by employing more structured deals to balance risk. These included the increased use of earnouts, contingent value rights, carve-outs, and spin-offs. There was also an increased number of deals structured with all or part stock consideration as opposed to all cash consideration. Typically, an acquirer structures a deal with all cash consideration when they have ample cash or access to financing and are willing to take on all the risk of a merger as they have high confidence in their ability to achieve synergies or strategic targets from the acquisition. As financing conditions tightened and the deal environment favored acquisitions for scale in more traditional and capital intensive industries, there was a notable increase in deals announced with stock consideration sharing the risk of the merger (and also the upside

[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 - Deals Intelligence

potential) with target shareholders. M&A activity declined for private-equity firms this year due to tighter financing conditions reducing the economics of leverage buyouts while sellers remained anchored to higher valuations and were unwilling to transact at a lower price. PE firms found a way to continue doing deals in a higher rate environment by purchasing a minority interest in companies allowing them to preserve capital by writing a smaller cheque while also allowing the target company shareholders to obtain capital while maintaining interest in the company should the valuation recover. While public and PE buyers certainly got creative through the year and new entrants stepped in to provide deal financing, the many headwinds faced by deal makers in 2023 drove global deal activity down to decade low levels.

As inflation cools, interest rate expectations trend lower and companies adapt to the post pandemic environment, the headwinds which impeded M&A activity in 2023 are turning into tailwinds which may bolster M&A in 2024. Equity markets while volatile through most of the year, saw a sharp recovery through year-end hitting new highs as confidence returned to the market. While economic and geopolitical uncertainty remains, savvy companies are seeking out opportunities to drive future growth and acquire the technologies and capabilities needed to compete and avoid disruption. The various factors impacting markets and growth expectations in 2023 created an environment where there was considerable divergence in the perception of value for a business making it difficult for buyers and sellers to come to an agreement on price. Investment banks and dealmakers have suggested that along with tighter and more expensive financing, the spread between the bid and ask of buyers and sellers was one of the key factors preventing deals from occurring last year. With equity valuations recovered from trough levels but still at a discount to intrinsic value buyers and sellers are more likely to find a mutually agreeable clearing price for more merger deals to materialize. Many PE buyers stayed on the sidelines last year despite the trillions of dollars in their coffers ready to be deployed into acquisitions. While these PE firms held off from deals when interest rates were at peak levels, many are approaching the end of their deployment period adding pressure to their timelines. PE firms don't collect fees until that capital is called and deployed so there is a strong incentive to do deals and with improving financing conditions it is likely a matter of when not if these deals materialize. There is a mosaic of factors and improving confidence that M&A is positioned to rise with the right incentives and conditions in place to get deals over the line.

SPAC Market Update

2023 saw the SPAC industry continue its collapse, declining to levels in line with its pre-pandemic scope and scale. The number of SPACs outstanding fell from 535 at the start of the year to 271 while the value held by outstanding SPACs fell from $116 billion to just $18 billion by year-end.[3] In December alone, 19 SPACs liquidated returning $5.3 billion to unitholders barely being offset by the 3 SPAC IPOs during the month that raised $200 million. Of the 271 SPACs active in the market today, nearly half are long-dated SPACs well past their initial maturity date which have been subject to various extension and redemption

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

© Copyright PenderFund Capital Management Ltd. All rights reserved. January 2024.

cycles resulting in their value held in trust being only a fraction of the initial amount raised. Given the challenges of a new, well capitalized SPAC finding a target and successfully closing a merger, we expect the majority of these extended SPACs to eventually liquidate and return their remaining capital held in trust back to unitholders.

"Overall, 2023 was a challenging year for M&A and merger arbitrage, but with a notable pickup in activity in the fourth quarter there are many reasons to be optimistic on the M&A outlook for 2024."

Outside of arbitrage, SPAC's have garnered and largely warranted their poor reputation as an investment vehicle. While structured ideally as a low-risk arbitrage investment, the structure of a SPAC results in sponsors maintaining an asymmetric informational, voting and economic edge at the expense and often to the detriment of unit holders. Given the economic interest provided to a sponsor in a successful deSPAC (typically 20-25% of the SPAC interest) there is tremendous incentive for a sponsor to close a merger deal which may not be in the best interest of public unitholders. During the SPAC bubble of 2020 and 2021 where market speculation peaked and excess capital flooded the market, SPACs became a coveted speculative investment, but as the market shifted the majority of SPACs have failed to find, and close, a merger with a target. This resulted in a wave of liquidations through much of 2022 and 2023. Those SPACs that did find a target and completed a merger have also struggled with at least 21 deSPACs going bankrupt in 2023 and many more requiring financing to keep operating.[4] We enter 2024 with a far more balanced SPAC sector with supply of capital held by SPACs and the demand for that capital by the few private companies looking to merger with a SPAC near an equilibrium. With the purchase of a SPAC effectively being similar to buying a discounted treasury bill and a call option, the value of that call option could increase in this more balance environment. It is still early days for a SPAC recovery and the number of SPACs outstanding should continue to dwindle as older SPACs liquidate, but there is likely to be opportunities for new SPACs in the coming year and we will be following the opportunity closely.

At the end of December there were 271 active SPACs in the market with assets of $18 billion, with 157 SPACs actively searching for targets. At the end of December 2023, SPACs searching for targets were trading at a discount to trust value, which provided a yield-to-maturity of 6.64%.[5] With SPAC arbitrage effectively equivalent to acquiring a Treasury Bill at a discount, SPACs currently provide a higher yield to US Corporate Investment Grade Bonds with lower credit risk, shorter duration and a tax advantage, as SPAC returns are primarily capital gains.

Portfolio Update

[4] https://www.bloomberg.com/news/articles/2023-12-27/spac-mania-s-ugly-end-yields-46-billion-of-investor-losses
[5] https://www.spacinsider.com/

Standard Performance Information for Pender Alternative Arbitrage Fund may be found here: https://www.penderfund.com/pender-alternative-arbitrage-fund/
This commentary is subject to the Disclaimer found here: https://www.penderfund.com/disclaimer/
All dollar figures are in USD unless otherwise indicated.
© Copyright PenderFund Capital Management Ltd. All rights reserved. January 2024.

There was a high level of activity in the Fund during December with several merger deals closing by year-end allowing the Fund to harvest those returns while a pick up of deals announced provided opportunities for that capital to be redeployed. In total, there were 19 merger deals held within the Fund that closed during the month while the Fund initiated position in 19 new deals. There has been a notable increase in merger deals with all or part stock consideration held by the Fund. In most cases these merger deals have the benefit of providing positive carry (we earn interest income on the net exposure of a low-cost short position with a smaller offsetting long position), a notable benefit in a higher interest rate environment. We are also seeing new merger deals announced with the companies, guiding us to more conservative expectations in the timeframe to closing. While these longer closing dates are the results of management being conservative given the hostile regulatory scrutiny faced in 2023, it is being applied to a wide subset of deals which are unlikely to face regulatory pushback. We believe this is creating mispricing opportunity where many of these deals are likely to close in a shorter period of time than expected by the market with the potential to realize a higher yield on the shorter duration. We are actively following many of these merger deals and opportunistically adding exposure when we believe there has been a mispricing of timing risk.

There has also been an uptick in SPAC extension redemptions through year-end which the Fund has also been taking advantage of although the total SPAC exposure in the Fund remains in the low single-digits. We may actively look to participate in more SPAC IPOs through 2024 and have seen recent SPAC IPOs being oversubscribed given the factors discussed in the SPAC Market Update. Our strategy remains focused on targeting small and mid-cap merger deals which have a greater tendency of being mispriced with less inherent deal risk. Historically many of our largest positions that have generated the biggest returns have been acquisitions of target companies held by Pender's equity portfolios. We believe the small cap industry and Pender's core investable unaversive within it is ripe for M&A. Risk appetite for small cap companies is apparently rising with many investment strategists recommend the category for investment consideration in 2024. The attractiveness of this opportunity will not be lost on acquirers who've been following a small cap target acquisition and want to close the deal before the valuation recovers further. It is still early days and markets remain unpredictable but we're excited about the potential for small cap M&A. At the end of December 2023, the Fund had 33 investments in small cap deals under $2 billion, 26 of which were valued at under $1 billion.

Outlook

2023 was a challenging year for merger arbitrage with a decline in deal activity and a more hostile regulatory environment resulting in extended periods to closing, higher deal breaks and less bidding wars occurring. Regulators were more hostile and politically motivated, applying novel theories of harm to block deals and expressing unprecedented levels of activism. Rising geopolitical tensions increased real and perceived deal-risk spanning from the Ukrainian/Russian war, ongoing tensions with China, rising Middle East conflicts and increased supply chain and energy security in a post pandemic world. While equity valuations recovered by year-end it was a challenging year for equity markets with US IPO

© Copyright PenderFund Capital Management Ltd. All rights reserved. January 2024.

volumes down 15% and US M&A activity down 11%. Deal negotiations stalled as buyers and sellers were too far apart on valuation and valuations on strategic merger deals hit a 15-year low. The challenging regulatory environment weighed on boardroom confidence curbing demand for larger transformational deals. Even small cap merger deals, the target universe for the Fund were subject to more regulatory scrutiny and geopolitical risk. While these factors impacted M&A and merger arbitrage in 2023, the short duration of the strategy provides investors with the ability to quickly adapt to market conditions and reprice risk to corresponding market factors.

We enter 2024 optimistic about the outlook for M&A and merger arbitrage. On the deal side, indications across the board from investment banks, advisors and company insiders all suggest that the M&A pipeline is robust. Rising equity markets have given management and boards the confidence needed to make deals with a growing number of companies in active dialogue. Shareholder activism is also on the rise as frustrated shareholders seek out ways to realize value in stocks trading at deep discounts to intrinsic value. As we head into proxy season, ineffective boards may become targets for replacement and increased shareholder dissent could bring an opportunistic acquirer to the table. The investment opportunity with merger arbitrage is also attractive with merger arbitrage yields in excess of 10% for average North American merger deals, a material premium to historic levels and a significant spread over high-yield bonds. In a more hostile regulatory environment, arbitrage investors can now benefit from the precedent of actions taken last year formulating a better understanding of what deals are likely to be targeted by regulators. After a string of losses by the regulators their resources are also stretched thin limiting the number of deals they can actively target. With wide spreads, an improved playbook for assessing deal risk and the potential for more M&A activity to materialize, 2024 could shape up to be a strong year for merger arbitrage performance.

Amar Pandya, CFA

January 17, 2023

© Copyright PenderFund Capital Management Ltd. All rights reserved. January 2024.