PENDER
ALTERNATIVE ARBITRAGE FUND

MANAGER'S COMMENTARY – DECEMBER 2022

Dear Unitholders,

The Pender Alternative Arbitrage Fund (PAAF) was up 0.2% in December, bringing year-to-date performance to 3.1%[1].

M&A Market Update

Global M&A activity ended 2022 with $3.6 trillion in total deal volumes, down 37% from last year's historic peak but still outpacing 2020 activity and in line with pre-pandemic levels[2]. The Technology sector led deal activity, accounting for a record 20% of overall value, followed by the Energy & Power and Industrial sectors. With 2022 seeing several notable leverage buyouts, it's not surprising that private equity-backed buyouts reached record levels this year and accounted for one-fifth of all deals. With over a trillion dollars at private equity firms still waiting to be deployed and public market valuations at a discount to private market valuations, buyouts by PE firms are likely to remain elevated in 2023.

M&A activity in 2022 was a year of two halves, with strong momentum from the historic peak activity levels in 2021 carrying into the first half of 2022. Despite spiking inflation, rising interest rates, geopolitical tensions and market volatility, deal activity remained elevated through the first two quarters of the year. The back half of 2022 saw a 33% decline in activity to $1.4 trillion as higher interest rates, recessionary fears and credit risk aversion slowed activity. As discussed in last month's commentary, we've recently seen private equity buyers and other acquirers find new, creative ways to finance deals. While it remains uncertain whether central banks have tamed inflation and interest rates have peaked, improved visibility on the path of interest rates may provide more confidence to acquirers and credit providers and lead to an increase in M&A activity.

SPAC Market Update

At the end of December, SPACs searching for targets were trading at a discount to trust, which provided a yield-to-maturity of 6.9%[3]. With SPAC arbitrage effectively reflecting acquiring a treasury bill at a discount, SPACs currently provide a higher yield than US Corporate Investment Grade Bonds[4] with lower credit risk, shorter duration and a tax advantage, given that SPAC returns are primarily capital gains.

The popping of the SPAC bubble that formed in 2020 and early 2021 created an unprecedented opportunity for SPAC arbitrage investors last year, with hundreds of SPACs with tens of billions of dollars in trust value trading at a discount to that value and approaching a maturity date where they would have to liquidate and return capital to shareholders. This wave of liquidations was amplified by the unintentional consequences of the Biden Administrations Inflation Reduction Act and its 1% excise tax that was perceived to obligate SPAC sponsors to pay the tax in the event of a liquidation. With the excise tax set to become effective this year and low prospects of finding and closing a merger with a target company, many sponsors elected to liquidate early, prior to the tax becoming effective. This drove a surge of year-end liquidations. While the IRS released guidance in early 2023, which clarifies the rules and is interpreted to exclude SPAC liquidations from the excise tax, the ship has sailed[5].

At the end of the year, 139 SPACs had liquidated and returned their capital to shareholders. December alone saw nearly 70 SPACs wind down and return capital to shareholders[6].

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[1] Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.
[2] https://thesource.lseg.com/thesource/getfile/index/78b4d1a3-f045-46ec-8fc6-e1f685505a9c?utm_source
[3] https://spacinsider.com/stats/
[4] https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY
[5] https://www.sidley.com/en/insights/newsupdates/2023/01/irs-guidance-on-1-percent-excise-tax-helpful-for-de-spac-transactions-with-private-targets
[6] https://www.spacresearch.com/newsletter?date=2023-01-03

The market cap of the SPAC sector at the end of 2022 was around $100 billion — roughly half its size at the start of the year — with 385 SPACs seeking targets, down from 535 SPACs at the same time last year. The size of the SPAC sector should continue shrinking as more SPACs fail to find or close merger deals with targets and return capital to shareholders, which is unlikely to be offset by new SPAC formations. In fact, SPAC IPO activity has reverted back to pre-pandemic levels, with 86 SPACs raising just over $13 billion in 2022, down 90% from the 613 SPACs that raised over $162 billion in 2021[7]. With market sentiment turning bearish, the cost of capital increasing and the disconnect between private and public market valuations inverted, SPACs will likely continue facing difficulties in finding and closing deals for the foreseeable future.

Portfolio Update

The Fund's positive performance in December was driven by a variety of factors, including the payout of proceeds from several SPAC liquidations and redemptions, the tightening of some wide-spread merger arbitrage deals and the closing of several merger deals held in the Fund. In December, the Fund had its highest positioning in SPACs since inception, with nearly half of the Fund invested in SPAC arbitrage deals, as we positioned the Fund to benefit from a wave of early liquidations or redemptions. With the proceeds from these liquidations received and a high level of M&A activity in December, much of that capital has been redeployed into merger arbitrage deals.

As discussed last month, the first quarter of 2023 is the final period that laps the peak of the SPAC bubble by the typical two-year maturity timeline, and while SPAC opportunities have declined, there currently remains a wide albeit dwining set of opportunities. As the SPAC sector shrinks to a new equilibrium, the yield on SPAC liquidations may decline while the yield offered by SPAC IPOs and the upside optionality of announcing a well-received business combination increases. Given that our primary focus is on merger arbitrage, we will take advantage of SPAC opportunities while they are available in the market and will wait for new opportunities to develop in the sector.

The Fund initiated positions in nine new or previously announced merger deals, and six merger deals held within the Fund closed. The environment for merger arbitrage remains highly attractive due to the high level of deal activity in North America, a higher than historical success rate of mergers closing and wider than historical relative and absolute spreads. We continue to focus our positioning on small and mid-cap merger deals that typically benefit from shorter duration relative to larger mergers, which face increasing regulatory pressures and extended periods to closing. Duration can be a key contributor to merger arbitrage performance because capital from closed merger deals can be redeployed into new deals, delivering a potentially higher annualized return. With many large and mega-cap mergers trading at wide spreads, we can position the Fund to take advantage of selective large-cap deals late in the closing process when the duration is shorter and the spread still provides a compelling return.

Fund holding Shaw Communications Inc. (TSX: SJR.B), which is being acquired by Roger Communications Inc. (TSX: RCI.B) was a key contributor to the Fund in December. The acquisition, which was announced in March 2021, was originally expected to close in the spring of 2022 but has seen significant delays since one of the key regulators, the Competition Bureau, filed court applications with the Competition Tribunal to block the merger. After weeks of hearings, testimony and oral arguments, the Tribunal ruled on December 29 in favour of the merger, dismissing the Bureau's application to block the deal. The shares appreciated by over 9% on the last market day of the year after this favourable ruling, and the market has now priced in a nearly 90% probability of the merger closing. Since this is a higher risk, large-cap merger subject to elevated regulatory and political risk, we have tactically managed our exposure to this deal through its tenure. The Competition Bureau appealed the Tribunal's decision in early January, so the merger is not a done deal and we will continue to reassess and manage our positioning in the Fund.

At the end of December, the Fund had 23 investments in small-cap deals under $2 billion, 15 of which were valued at under $1 billion. A key benefit of our focus on small and mid-cap merger deals is our ability to take advantage of organic deal flow from Pender's equity portfolio and leverage Pender's existing insights,

[7] https://www.sidley.com/en/insights/newsupdates/2023/01/irs-guidance-on-1-percent-excise-tax-helpful-for-de-spac-transactions-with-private-targets

analysis and trade execution competencies in small and mid-cap equities. This was evident in December, with the Fund benefitting from an increase in activity in Pender's core equity universe. Maxar Technologies Inc. (TSX: MAXR), a long-term holding in the Pender Small Cap Opportunities and Pender Alternative Special Situations Fund, announced an acquisition offer by a private equity firm in mid-December. As a top holding in our equity funds, we had significant insights into the offer and internal assessments of private market value, given that a take-out was part of our thesis for the company. Leveraging these insights allowed us to quickly build a position in what we believe is a high-quality deal.

Former equity fund holdings Freshii Inc. (TSX: FRII), Qumu Corporation (NASDAQ: QUMU) and Waterloo Brewing Ltd. (TSX: WBR) also announced acquisitions in the month. We leveraged our existing research and insights in assessing the mergers, which have been initiated as holdings in the Fund. The PAAF will continue to leverage Pender's existing insights, analysis and trade execution competencies in small and mid-cap equities, tactically adding value when opportunities are presented.

Outlook

As the calendar turns to 2023, 2022 can be succinctly summarized as a challenging year for investors. Spiking inflation and a steep rise in interest rates led to declines across most assess classes, with bonds and stocks falling in tandem, providing investors with few places to hide. While inflation appears to be moderating and there may be more visibility on the near-term path of interest rates, it remains unclear when inflation could return to target levels and where terminal interest rates will ultimately settle. The era of accommodative monetary policy, characterized by low volatility, negative correlation and central banks backstopping investors at every stumble, may be behind us. Many of the issues driving the spike in inflation, including geopolitical tensions, supply chain disruptions, climate impacts, the onshoring of strategic production and aging demographics, may not be resolved in the short term. With these uncertain market conditions, a non-correlated, event-driven, alternative strategy can be a solid compliment to a portfolio.

As we assess the market opportunity in arbitrage, the current opportunity in both SPAC and merger arbitrage remains highly compelling. SPAC arbitrage yields currently provide a superior opportunity from both a return and risk perspective relative to investment grade bonds in our view. Despite fewer SPACs remaining, there remains a wide set of attractive investment opportunities for the Fund. 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. We believe 2023 could see a spike in M&A activity in North America, especially in Pender's core universe of small and mid-cap companies, where current market valuations are at steep discounts to our assessment of private market valuation.

The Pender Alternative Arbitrage Fund was launched with the goal of providing investors with a low-risk, low-volatility, absolute return-focused investment strategy that offers diversification benefits to investors with low correlation to traditional assets. We are pleased to have delivered on that goal in 2022 and will continue to focus our time and efforts on the inputs necessary to deliver on that goal over the long term. After a challenging year in traditional assets, alternative investment strategies like risk arbitrage have demonstrated their value and earned a place in investors' portfolios.

Amar Pandya, CFA
January 18, 2023

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PenderFund Capital Management Ltd.

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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