

PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – FEBRUARY 2023

The Pender Corporate Bond Fund returned -0.3%¹ in February, a relatively strong performance amidst a market that saw larger price declines in both high yield and investment grade bond benchmarks.

Performance at the holdings level was mixed, with particular strength coming from certain distressed lines, including Emergent BioSolutions Inc. This specialty biopharma entity announced the disposition of a non-core travel health business, the proceeds of which should help the company navigate a significant near-term debt maturity. Floating rate loans and rate-reset preferred shares were also amongst the Fund's better performers as benchmark rates advanced.

Weaker positions included most investment grade holdings, as the five-year government benchmark yield in both Canada and the US rose in February. Convertible bond positions in precious metals miners First Majestic Silver Corp. and SSR Mining Inc. were notable decliners in sympathy with the weakness in that sector.

Real Estate vs Bonds – Doing the Numbers for an Income Oriented Investor

Canadian investors wanting to generate portfolio income have long turned to residential real estate as a source of stable returns. While net property rental income has not always exceeded yields from fixed income instruments, over the past decade, this shortfall was usually more than compensated for by capital appreciation. However, times can change.

This month we look at one of the more fundamental portfolio decisions that many investors face – bonds versus residential real estate. And, having run a few numbers, we argue that a portfolio allocation to corporate credit offers higher income, with considerably less potential downside, than even a well-executed program of residential real estate investing in one of Canada's largest cities.

Yield Comparison: On the bond side of the equation, we consider a selection of North American corporate bonds (see table 1) with yields at February 28 of approximately 8%, all of which are holdings of this Fund. For real estate, we consider the midpoint of multi-family apartment "cap rates"² in Canada's three largest cities: Toronto, Montreal and Vancouver. As of December 31, 2022, according to property brokers Cushman & Wakefield, multi-unit residential property paid its owners between 2.5% and 5.5% in the largest Canadian cities. So as a starting point, the bonds pay approximately twice as much income as the midpoint of a residential real estate market.

Table 1: Valuation Coverage – Selected Corporate Bonds Yielding an Average of 8%

Company	Bond Coupon	Bond Maturity	Bond Yield (02/28/23)	Coverage at Current Valuation	Coverage at 10 Year Low for EV/Sales	Coverage at 10 Year Average for EV/Sales
Tamarack Valley Energy Ltd.	7.25%	5/10/2027	8.4%	3.3x	3.2x	6.5x
Abercrombie & Fitch Co.	8.75%	7/15/2025	8.4%	9.0x	2.1x	6.2x
Varex Imaging Corporation	7.88%	10/15/2027	8.4%	4.9x	4.0x	6.5x
Pediatric Medical Group Inc.	5.38%	2/15/2030	7.5%	3.1x	2.5x	6.0x
Hecla Mining Co.	7.25%	2/15/2028	7.9%	7.7x	2.8x	5.6x
Average			8.1%	5.6x	2.9x	6.1x

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 A cap rate is simply the net rental yield after property specific costs, divided by the capital price of purchasing a property.

Downside Protection: It is one thing to earn a coupon, but quite another to ensure that the coupon is generated from an asset that is well supported by fundamental value. For the corporate bonds, we considered the current level of valuation coverage - that is, the degree to which the estimated value of the issuing company exceeds the total amount of debt at or above the level of our bond. We also considered the coverage in three circumstances: based on the current market prices; based on long-term average enterprise value multiples; and based on decade-low enterprise value multiples. We observe that, even valuing these issuers based on a 10-year minimum enterprise value to sales multiple, the 8% notes are more than two times covered by the value of the issuing companies.

The downside protection argument for the real estate investment in the current market environment is far less certain. First, investors in real estate such as houses or condominiums typically are not sitting in the senior capital position. Capital priority, in fact, is often surrendered to a bank that may have funded a first mortgage. So, any diminished value of the property is a direct mark-to-market hit to the investor.

A second concern for real estate investors is the very low level of cap rates (or rental yields) relative to history. One recent study noted that real estate cap rates in Toronto, Montreal and Vancouver were all at least 1.5% below their longer-term average as measured by the spread of cap rates over Canada 10-year bonds³. If one were to apply a 1.5% higher cap rate to the midpoint of the Toronto-Montreal-Vancouver current cap rate, the impact on underlying real estate value would impact values by more than 25%.

Of course, markets are not completely uniform and there may be some attractive property deals even in the current environment. But, given the choice of real estate and bonds in this context, we prefer bonds due to their higher income generation and capital exposure, which we deem to be far less risky.

New Positions

In February, we added a position in the 2028 unsecured bonds of Brazilian payments processing specialist, StoneCo Ltd. An equity portfolio holding of Berkshire Hathaway, we believe StoneCo Ltd. stands to gain from the continued penetration of its payments platform to smaller merchants and service businesses across Brazil. StoneCo Ltd. has also developed an attractive niche business in the financing of short-term receivables due to merchants from major domestic banks that result from credit card transactions. Despite the company's solid credit rating (Moody's rates StoneCo Ltd. on par with Brazil's sovereign USD rating), and ample excess cash balances, the company's bonds have traded down into the 60s to yield more than 12% to a 2028 maturity.

On the stodgier side of the Fund, we continued to maintain weightings in relatively short-term investment grade issuers and added to our holdings of PepsiCo Inc.'s 2024 maple bond, which yielded approximately 4.9% at month end. We expect that the rapid move in interest rates will create additional stress in some quarters and we are comfortable maintaining a supply of dry powder in anticipation of future opportunity.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at February 28 was 7.8% with current yield of 5.6% and average duration of maturity-based instruments of 3.8 years. There is a 2.3% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 1.7% of the total portfolio at February 28.

Geoff Castle
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³ Colliers Canada Cap Rate Report Q3 2022