



ALTERNATIVE ARBITRAGE FUND

MANAGER'S COMMENTARY – FEBRUARY 2023

Dear Unitholders,

The Pender Alternative Arbitrage Fund was up 0.8%¹ in February.

M&A Market Update

Global M&A investment totalled \$291 billion through February, down from the \$729 billion invested in the same period last year². While M&A deal activity was down in most major regions, including the US where there was a 67% year-over-year decline to \$131.5 billion, Canada remained a bright spot, with activity roughly flat over the last year at \$10.8 billion of deal value announced.

Unlike the last two years, when the technology sector led merger deals, 2023 is seeing deals materialize from a more diverse range of sectors. The industrial sector has led M&A deal activity to date, followed by the energy & power, technology and real estate sectors. We expect technology sector M&A to continue representing a leading share of deal flow over the next year, but we are encouraged by financial and strategic buyers stepping up and seeing the opportunity to do deals in more sectors and industries.

The relative slowdown in M&A activity this year is a likely consequence of the current macro environment, marked by higher inflation, interest rates and market volatility. The large losses taken by banks which provided syndicated financing for many of last year's largest leveraged buyout (LBO) deals have also impacted the financing market for M&A deals. With banks limiting or halting on writing debt financing for leveraged buyouts, private equity deals may be hindered or delayed, which could be driving a decline in the volume of M&A deals.

While we have previously discussed new and creative ways in which private equity firms are financing deals, including self-financing without leverage, we are starting to see new players emerge in this market - a positive sign for future M&A potential. Oaktree Capital recently announced that the firm was seeking to raise \$10 billion in a new fund that will help finance large private equity takeovers by offering loans to leveraged buyout groups³. With banks cutting back on the size and number of loans they offer to acquirers, this is an opportune time for new players to step in and provide this much-needed financing. With private equity incentivised to do deals, approximately \$1 trillion in PE coffers ready to be deployed and public market valuations being far more attractive than those in the private markets, an increase in buyout debt financing could be the spark that sets off a surge in M&A deals.

SPAC Market Update

At the end of January 2023, SPACs searching for targets were trading at a discount to trust value, which provided a yield-to-maturity of 6.0%⁴. With SPAC arbitrage effectively equating to acquiring a treasury bill at a discount, SPACs currently provide a higher yield than US Corporate Investment Grade Bonds⁵ with lower credit risk, shorter duration and a tax advantage, as SPAC returns are primarily capital gains.

Given challenging market conditions, the more than 330 SPACs still competing for targets, negative sentiment for SPACs and a terrible track record of de-SPAC performance, 2023 continues to present SPAC sponsors with the nearly insurmountable task of finding and closing a merger with target prior to maturity⁶. We believe the majority of SPACs will be unsuccessful in closing a merger prior to maturity and

¹ This Pender performance data point is for Class F of the Pender Alternative Arbitrage Fund. Other classes are available. Fees and performance may differ in those other classes.

² Refinitiv Investment Banking Scorecard – Deal Intelligence I as March 2, 2023

³ <https://www.ft.com/content/dadcc767-e07c-4c10-aa18-c99b412aa345>

⁴ <https://spacinsider.com/stats/>

⁵ <https://fred.stlouisfed.org/series/BAMLC0A4CBBEY>

⁶ SPAC Research

will therefore be forced to liquidate and return capital to shareholders. Through 2023, over 330 SPACs are set to mature, representing over \$75 billion in capital. While no longer a market with the size, liquidity and (more pertinently) return potential to attract speculators and larger investors, the SPAC industry should remain an attractive market for arbitrage investors throughout the year. Our strategy remains focused on targeting SPACs trading at a discount to trust value that offer an attractive yield held through liquidation.

March 2023 laps what was effectively the end of the peak of the SPAC bubble, which occurred from Q3/2020 to Q1/2021 by the typical two-year maturity period. We have already seen the wave of SPAC liquidations from this bubble-popping occur last year and spike in December 2022 with the SPAC sector halving in size through 2022. Liquidation activity has remained elevated for the first two months of this year, with approximately 33 SPACs liquidating \$9.8 billion in trust value back to investors. March 2023 is expected to see over 90 SPACs liquidate and return more than \$25 billion in trust value, and a further \$37 billion in liquidations is expected throughout the rest of the year. As the SPAC sector returns to an equilibrium, new opportunities may emerge in announced deals or SPAC IPOs, but we remain cautious and focused on our liquidation strategy.

Portfolio Update

After a lack of activity or progress on merger deals held in the Fund last month, February 2023 saw a pickup of activity narrowing the spreads of many deals held within the Fund as various approvals, consents or deal closings were achieved. February 2023 was an active month, with the Fund initiating positions in 17 new or previously announced merger deals. 12 merger deals held within the Fund also closed during the month. While mega- and large-cap M&A activity has slowed down this year partly due to an increasingly hostile regulatory environment (which has made it challenging to ensure a merger will be approved) small- and mid-cap M&A activity and expectations remain elevated. Across a broader range of sectors and industries, we are seeing more acquirers take advantage of low, and in some cases dislocated, public market valuations for both strategic and financially motivated acquisitions.

We have recently seen key US regulators including the DOJ, FTC and FCC take unprecedented and highly politicized actions in blocking large mergers, adding further uncertainty and unpredictability to merger deal analysis. Fund holding Tegna Inc. (NYSE: TGNA), which received a proposed acquisition offer by US hedge fund Standard General L.P., is one of the companies that has faced this unprecedented regulatory pressure, with the FCC ordering a hearing that would likely extend the proposed transaction past its final extension date in May, effectively blocking the merger. Two of the four current FCC commissioners supported the deal and criticized the FCC's actions.

Our analysis of Tegna, which was a previous holding in the Pender Alternative Special Situations Fund, suggested that it was a high-risk deal when the acquisition was announced a little over a year ago. We patiently waited until the majority of consents, approvals and remediations were achieved while the spread still provided an attractive return. In recent weeks, the market started to price in a higher likelihood of the merger being approved and was caught off-guard by the FCC's actions. Given this challenging regulatory environment, we expect to focus an even greater portion of the Fund to small- and mid-cap merger deals going forward, and we expect to avoid larger mergers with elevated deal risk. Exhibiting this unique and differentiated positioning, at the end of February 2023, the Fund had 29 investments in small-cap deals under \$2 billion, 21 of which were valued at under \$1 billion.

The Fund's investment in Noranda Income Fund (TSX: NIF.UN) highlights the disconnect in public market valuations from intrinsic to market value and the unique opportunities afforded in small- and mid-cap merger deals. Noranda is an income trust that owns an electrolytic zinc processing facility and other ancillary assets located in Salaberry-de-Valleyfield, Québec. Glencore Canada Corporation owned 25% of Noranda while public shareholders held interest in the other 75% of the income fund. On January 9, 2023,

Noranda announced that it had entered an agreement with Glencore, by which Glencore would acquire the 75% of the company not owned for C\$1.42/share.

In the days and weeks following the announcement, key shareholders came out against the deal, viewing it as an opportunistic attempt to acquire the business at a depressed price. With the board, Glencore and the dissenting shareholders likely negotiating in the weeks that followed, the company announced on February 23, 2023 that the offer had been increased by over 39% to C\$1.98/share, with support agreements signed by these key shareholders. We initiated and continued to build a position in this deal after the initial offer was made, as it traded at a spread providing an attractive yield. 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

There were few places for investors to hide in February 2023, with stocks, bonds and commodities all reversing from January's rally. The S&P 500 (USD) slid 2.4% in the month, the NASDAQ (USD) fell 1.0%, oil prices were lower and gold suffered its worse month since June 2021. Rising inflation worries led bonds to their worst February in three decades, with the Bloomberg Global Aggregate Bond Index (USD) declining by over 3.3% after short and long-term yields increased during the month. The positive performance of the Fund in a month where most traditional asset classes were declining demonstrates the value of adding a non-correlated absolute return-focused alternative strategy like merger arbitrage to a portfolio.

While central banks started the year with more dovish commentary on the pace of rate hikes, recent inflation and employment data have pushed rate expectations higher. The BOC recently stressed that its pause in rates was conditional and that they will be ready to raise rates should inflation not come down quickly or the economy continue to run hot. In the US, the Fed has been much more hawkish, suggesting rates may need to go higher to temper inflation. With greater uncertainty on the path of interest rates, adding an allocation to merger arbitrage, which has historically been an effective interest-rate hedge and a source of low-volatility returns, could be prudent for investors.

While the size of the SPAC sector continues to shrink, SPAC arbitrage yields still provide investors with a relatively attractive, low-risk and tax-efficient return relative to bonds. We will be selective and yield-sensitive in which SPACs we hold, but we continue to see opportunities in the SPAC sector. The opportunity in merger arbitrage remains compelling and after recent unprecedented actions by key US regulators targeting large merger deals, we will be increasing our exposure to the Fund's key focus of small- and mid-cap merger deals and reducing our exposure to opportunistic large-cap mergers in which we have occasionally invested in the Fund. We continue to see favourable tailwinds in small- and mid-cap equity markets, and this provides us with confidence that deal activity could increase in our universe.

Amar Pandya, CFA
March 10, 2023



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All dollar figures are in USD unless otherwise indicated.

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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