PENDER
ALTERNATIVE ARBITRAGE FUND

August 2023

Manager's Commentary

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Dear Unitholders,

The Pender Alternative Arbitrage Fund was down -0.3%[1] in August 2023.

M&A Market Update

Global M&A activity totalled $1.84 trillion through the first eight months of 2023, down from $2.56 trillion last year. While overall activity is down, certain sectors, including materials, healthcare and consumer staples have managed to drive a year-over-year increase in total deal activity.

The materials sector is seeing increased consolidation, which is being driven two factors. The first driver is the demand for raw materials required for the energy transition, and the second driver is the challenge to develop new mines due to environmental and regulatory concerns. The healthcare sector is experiencing M&A driven by a lack of capital in the biotech space and demographic and technological trends influencing management teams and boards to acquire new distributions and capabilities. Consolidation in the consumer staples space is being driven by higher input costs and the need to make supply chains more robust.

Across all sectors and industries, rising prices are influencing how businesses operate and impacting strategic decisions. While rising inflation, and the corresponding increase in interest rates by central banks to tame it, has been a damper on M&A this year due to higher funding costs, it has also been a motivator for many merger deals. The surge in inflation experienced over the past year and a half has driven many companies to consider mergers to achieve greater scale and unlock potential cost synergies through efficiencies and increased bargaining power.

As discussed last month, a development in the M&A industry this year has been the hostile regulatory environment targeted towards large cap merger deals. Despite aggressive action by regulators to halt and prevent merger deals, the letter of the law still matters in merger cases and regulators that overstep their authority may be subject to penalties. This was demonstrated in August, when the Competition Tribunal ordered the Commissioner of Competition to pay millions to Rogers Communication Inc. (TSX: RCI) after the Tribunal found that the Commissioner "adopted an unnecessarily contentious approach" in trying to block the Rogers merger with Shaw Communications Inc.[2] (TSX: SJR.B). Despite Shaw agreeing to divest its wireless business to Quebecor Inc. (TSX: QBR), the most contentious component of the merger, the regulator continued to aggressively try to block the deal. The Commissioner was found to have engaged in unreasonable behavior, with Federal Court

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[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] https://www.bloomberg.com/news/articles/2023-08-29/rogers-wins-costs-as-court-blasts-unreasonable-antitrust-czar

Chief Justice Paul Crampton writing that the Commissioner's position "was intransigent and should now have consequences." The Tribunal ordered the Commissioner to pay roughly $9.7 million to Rogers and $3.2 million to Shaw for legal fees and costs. While these proceeds likely reflect a fraction of the legal fees incurred by Rogers and Shaw, it does send a strong message to regulators. Consumers and corporations need effective regulators to protect markets and act as a watchdog under the purview of their duty and authority. Unfortunately for taxpayers, when a regulator oversteps those boundaries, they may be on the hook.

SPAC Market Update

The ongoing decline of the SPAC sector continued during the month as SPACs approach their maturity date and are redeemed or liquidated for trust value. In total, 7 SPACs liquidated in August, returning $1.7 billion to unitholders.[3] There was only one SPAC IPO during the month raising just $75 million, resulting in the total amount of capital held in trust by all SPACs at the end of August falling to just over $27 billion.

While the SPAC sector continues to shrink as more SPAC sponsors throw in the towel and close down returning capital to shareholders, some signs of irrational exuberance reminiscent of the hay-days of the 2020-2021 SPAC boom have emerged. Of the 11 SPAC mergers that were closed during August, nine were trading below $10 at month end with more than 90% of capital held by those SPACs redeemed prior to closing. However, the combination of SPAC Black Spade Acquisition Co with Vietnamese automaker VinFast Auto Ltd. (NASDAQ: VFS) saw its value more than triple on the first day of trading, giving it a valuation of $85 billion. In the days following its public debut, the deSPAC company continued its march of absurdity, peaking with a valuation of $159 billion, surpassing the value of Ford Motor Company and General Motors Company combined before plunging down. While this rally was driven by the company's miniscule public float, which restricted liquidity and price discovery making it a ripe target for a "meme stock," it may lead more SPAC sponsors to stick it out, extending their maturity to find a target in the hopes of a similar payday.

At the end of August, there were just under 351 active SPACs in the market with assets over $27 billion, with less than 185 actively searching for targets. At the end of August 2023, SPACs searching for targets were trading at a discount to trust value, which provided a yield-to-maturity of 4.7%.[4] With SPAC arbitrage effectively equivalent to acquiring a Treasury Bill at a 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.

Portfolio Update

After a slow summer, M&A activity picked up in August, with dozens of North American merger deals announced during the month. Reflective of the hostile regulatory environment, only one mega-merger over $10 billion was announced during the month with the smaller

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

sized deals spanning a variety of sectors and industries. Through the month of August, the Fund initiated positions in 20 new or previously announced mergers, while nine merger deals held within the Fund closed during the month. Performance in August was impacted by a regulatory challenge to a merger deal held by the Fund and the widening of spreads in certain other deals driven by regulatory approval delays and extensions to closings. Merger arbitrage spreads remain wide and relevant for our Fund, and the spread gap between small cap merger deals has narrowed as several large and mega-cap merger deals closed, were terminated or saw a regulatory hurdle cleared resulting in a tightening of their spreads. This development represents a favourable environment for our small and mid-cap focused strategy and allows us to benefit from a wider spread environment while avoiding the higher deal and duration risk for larger merger deals. At the end of August 2023, the Fund had 38 investments in small-cap deals under $2 billion, 30 of which were valued at under $1 billion.

A key detractor to the Fund during the month was the position in Quebec-based Velan, Inc. (TSX:VLN) a global leader in the design and production of valves and traps. In February, the company announced that it had accepted an offer to be acquired by Dallas-based Flowserve Corporation (NYSE: FLS), a leading global provider of flow control products for C$13/share. With a total purchase price of $245 million including net debt, this was a small tuck-in acquisition with Velan expected to be folded into Flowserve's Flow Control Division with modest cost and revenue synergies expected to be realized. With support from controlling shareholders, no antitrust issues or security issues of concern for Canadian regulators and the deal not subject to any financing conditions, this merger appeared to be a straightforward and high-quality merger and we initiated a position in the deal during the summer. Reflecting the current uncertain regulatory and geopolitical environment, Velan's France-based business, Velan SAS, which represents nearly 25% of revenue, was revealed to have attracted the attention of French politicians during the month who are looking at ways to prevent assets they deem strategic from falling into US hands. The most security-sensitive part of Velan's French business, a nuclear-submarine supplier, was already carved out of the deal and expected to be sold to a domestic buyer. The spread widened during the month as France's efforts to block the deal were revealed and both companies have agreed to extend the merger closing date as they work to find a solution with the French government. We cut our position in the Fund when these developments were disclosed during the month and maintain a small position in the deal as we continue to closely follow the progress and developments of the merger.

A deal with plenty of drama with a bidding war benefitting the Fund is the investment in Sculptor Capital Management Inc. (NYSE: SCU). Sculptor is a US-based hedge fund manager with $34 billion in assets under management across a variety of alternative mandates. The company has a storied history. Founded by Daniel Och in 1994 and formerly known as Och-Ziff Capital Management, the hedge fund grew quickly to manage a peak of $50 billion by 2005 and then went public two years later in 2007. The company was found to be involved in a major bribery scandal which led to criminal charges and a large settlement to the Department of Justice (DOJ) and Securities and Exchange Commission (SEC). Daniel Och stepped down in 2019 with his protégé Jimmy Levin, who joined the firm in 2016, taking the helm and the company eventually rebranding to Sculptor. Och, who has since soured on his former protégé, sued the company in 2022 over Levin's excessive pay of $146 million. With that lawsuit settled, the company was then put up for sale. In July, after a thorough sales process, Sculptor announced it would be acquired by Rithm Capital Corp. (NYSE: RITM) for $11.15 per share, with Levin remaining CEO albeit with a salary capped at a *paltry* $30 million annually. We initiated and built a position in the deal and then on August 20, a group of high-profile hedge fund managers including William Ackman made a higher counteroffer for the firm. There has been plenty of subsequent mudslinging with Och and another former CEO releasing statements against the Rithm deal and expressing their frustration with the board. The board has declined to engage with the interloping bidders, maintaining that the current offer with Rithm is in shareholders' best interest given its certainty. With the latest offer at $12.76, a 14% premium to Rithm's deal, Sculptor shares are trading through the deal price with the board still not concluding that this higher offer represents a superior proposal. With the egos and deep pockets of many of the players involved, there is likely to be further drama to come and we will be diligently managing our exposure to the deal.

Outlook

While 2023 has been a more challenging year for merger arbitrage, we are seeing encouraging signs across the board, specifically the accelerating pace of deal activity, as well as the spread environment widening and more appropriately reflecting deal risk and the predictability of the regulatory environment improving. Several wins against regulators over the summer have set a new precedent and may deter regulators from overstepping with new, novel and unreasonable theories of harm in their attempt to challenge a proposed merger. The new guidelines proposed by the Federal Trade Commission (FTC) and DOJ currently seeking public comments, in addition to modifications being made to the Canadian Competition Act by the Liberal government, may eventually lead to broad changes in M&A markets and the assessment of merger risk. Still, the letter of the law and historical precedent should still determine whether a merger is approved or not. A return to a regulatory environment with increased predictability and transparency should be a driver for more deal activity and improved merger deal risk assessment, a potential tailwind for risk-adjusted returns.

The valuation gap between small and large cap companies continues to widen, creating an environment ripe for M&A activity. More signs of broad-based deflation in Canada and the US and improved visibility on the path of rate hikes is improving the confidence of acquirers to act opportunistically and make a deal. As we've previously discussed, there are strong incentives for both acquirers and sellers of companies with abundant capital within corporate balance sheets and PE firms and motivated sellers hoping to unlock value in undervalued businesses. We continue to see pent-up demand for deal activity within our equity funds and in our broader small cap universe with a boost to organic-deal flow from other Pender mandates, historically a key driver of potential returns in the merger arbitrage strategy.

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September 19, 2023