

Manager's Commentary

Geoff Castle

The Pender Corporate Bond Fund enjoyed another profitable period in July, returning 2.6%¹. Several specific credit catalysts, including a takeover of a holding, boosted July performance. Meanwhile, a Bank of Canada rate cut, and growing expectations of Federal Reserve easing, resulted in a generally buoyant bond market that provided further tailwinds.

Key contributors for the period included our position in Desktop Metal Inc convertible bonds that surged 50% on an announced takeover bid. Other drivers included a 20% gain in Emergent BioSolutions Inc. 2028 notes on a large contract win and asset sales. We trimmed our weighting in Emergent which has now rallied from the mid 30s to the mid 70s since February. Further strength came from rallies in Lucid Group Inc. and OPKO Health Inc. convertible bonds as catalysts led to gains exceeding 10% in July.

There were not many weak lines in July, but we did see further softness in the American Tire Distributors' (ATD) term loan. ATD's cash flow has been pinched by the combination of lingering impacts of last year's supply chain disruptions and higher interest costs on its floating rate debt. We believe that both problems are likely to abate later this year.

Fruits from the Garden of Unpopularity

Looking at some of the top contributors from July, we reflect on how important it has been for us to investigate the capital structures of extremely out-of-favour companies. Each of this month's large gain positions became opportunities for us due to multi-year of bouts of unpopularity and, eventually, indiscriminate selling by other investors. Prior to its announced takeover Desktop Metal's equity recently hit a low, down 99% from its 2021 high. Lucid Group (-96%), Emergent BioSolutions (-99%) and OPKO Health (-96%) also experienced similar declines from their peaks.

Equity market meltdowns often beget low securities prices for bonds. And so, bonds issued just a few years ago at par by Desktop Metal Inc. fell to \$0.50. Lucid and Emergent's bonds fell to the 30s. And, in the case of OPKO, to remain liquid, the company was forced to issue convertible bonds with a \$1.15 strike price. That was quite a discount from our own estimate of reasonable fair value of at least \$2 per OPKO share.

But notwithstanding the low bond prices, we found solid credit support in these structures. Lucid had significant cash resources and the support of the deep pocketed Saudi Arabia's Public Investment Fund (PIF). OPKO had a solid royalty interest in Pfizer's quickly growing growth hormone franchise. Desktop Metals had the emerging 3-D printing industry's most sought after metal component capabilities. And Emergent was marketing the fast-growing overdose recovery therapy, Narcan, amongst other strengths.

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.

In each of these cases there was enduring real business value. But the issuers were caught up in a price spiral which had much more to do with equity holders liquidating losses than it had to do with business fundamentals. By the end of their declines, few wanted to invest even in the debt of these issuers any price. And often we found ourselves bidding alone for the bonds, which is a nice position to be in because capital earns higher returns where it is scarce.

The price pops in the bonds this month resulted (finally!) from fundamental factors swamping sentiment. Desktop Metals agreed to be acquired. Emergent BioSolutions and OPKO both enjoyed value-crystallizing asset transactions. And Lucid benefitted by inference as Volkswagen invested \$5 billion into a joint venture with its electric vehicle rival Rivian Automotive. Popularity be damned, good things happen to cheap companies.

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New Positions

July was a busy month for portfolio transactions and the team uncovered a number of new opportunities.

One of the more promising opportunities we saw was in the 8% secured notes of **Spirit Airlines Inc.**, maturing September 2025. Spirit has become distressed in the wake of its terminated merger with fellow discount airline JetBlue Airways Corporation, and the 8% notes have traded down recently to around 60% of par value. However, Spirit does have key credit strengths including its holdings of over \$700 million in cash and 73 owned aircraft, many of which are unencumbered by credit liens. We consider the collateral available to the secured notes to be sufficient to provide ample recovery in a reorganization or allow for a significant enhancement to the notes’ trading value in the event that holders negotiate a later maturity date with the company.

We also added a position in the 5.75% convertible notes of New Mexico-based utility operator **PNM Resources Inc.** PNM’s share price was recently depressed due to the failure of an acquisition attempt for the company. We like the credit quality of BBB rated PNM, whose business consists entirely of regulated utility assets in New Mexico and Texas. With PNM’s share price less than 15% above the convert’s strike price, the convertible bond has healthy equity optionality potential. However, at the same time, a cash yield of over 5% provides reasonable downside price support.

Also in July, we added a position in the 6.5% 2027 notes of **Energean PLC**, an oil and gas producer active in the Mediterranean region. Energean has recently entered into an agreement to sell its Egyptian, Italian and Croatian assets to Carlyle International for \$820 million purchase price, \$450 million of which will be used to repay in full these notes. We find the bonds, priced at a discount to par, attractive as a shorter-term investment.

Fund Positioning

The Corporate Bond Fund yield to maturity at July 31 was 7.7% with current yield of 5.4% and average duration of maturity-based instruments of 4.4 years. The Fund holds a 4.0% weight in distressed credit instruments where positions are held for a target value lower than par, and therefore the headline yields of these securities are not included in the foregoing calculation. Cash represented 2.1% of the total portfolio at July 31.

Geoff Castle*August 7, 2024*