MAXAM
CAPITAL MANAGEMENT

Maxam Arbitrage Fund – Q3 2022 Commentary

Dear fellow investors,

The Maxam Arbitrage Fund[1] gained +0.24% in the third quarter of 2022.

Following a risk-on rally from mid-July to mid-August, equity markets (and bonds) had a terrible final six weeks of the quarter after central banks, notably the U.S. Federal Reserve, threw cold water on investors by reiterating their commitment to keep raising interest rates to battle stubborn inflation.

Arbitrage again held up very well relative to the equity and bond market weakness – demonstrating its value as an alternative source of returns and a portfolio diversifier. We continue to see attractive arbitrage spreads to deploy capital into.

	Sep 2022	Q3 2022
Maxam Arbitrage Fund[1]	-0.38%	+0.24%
S&P/TSX Composite	-4.59%	-2.21%
S&P/TSX Small Cap	-7.27%	-3.04%
S&P 500	-9.33%	-5.26%
NASDAQ	-10.49%	-4.11%
MSCI World	-8.49%	-4.81%
iShares Core CAD Universe Bond Index ETF	-0.67%	+0.35%
Vanguard Total Bond Market ETF	-4.18%	-4.65%

Source: Maxam, Bloomberg.

State of the arb market.

The challenging investment environment continued to impact merger arbitrage with spreads on existing deals generally moving wider during the quarter on average. Higher interest rates are taking their toll on the credit markets and impacting spreads on deals requiring financing, most notably leveraged buyout transactions.

Also continuing to impact arbitrage spreads and deal timelines is the increased scrutiny that U.S. and some foreign regulators are applying to select transactions – typically involving larger cap companies in industries deemed more sensitive to competition concerns. However, in late September we saw one of the U.S. antitrust agencies, the Department of Justice (the "DOJ"), lose their attempt to block two transactions: UnitedHealth's acquisition of Change Healthcare and U.S. Sugar's acquisition of Imperial Sugar. A positive sign for arbitrageurs.

Despite the challenging environment we continue to see transactions close on terms and generally within expected timelines. Notable closings occurred in some of the arb community's most-watched deals, including: Vista Equity Partners leading a consortium in a leveraged buyout of Citrix Systems; Ali Group's acquisition of Welbilt Inc; and Thoma Bravo's leveraged buyout of Sailpoint Technologies.

Existing transactions and new deal announcements during the third quarter continued to provide us with a robust opportunity set to invest in – highlighted by attractive merger arbitrage yields of near 13% annualized on average[2].

The fund invested in 22 new deals during the quarter, had 15 successful deal closures and experienced no deal breaks. As of September 30, the fund held 39 merger arbitrage positions, diversified across market cap, deal type and industry.

Owned deals that successfully closed during the quarter included[3]: Citrix Systems; Welbilt Inc; Sailpoint Technologies; FAX Capital Corp; GTY Technology Holdings; Points International; and Redline Communications.

Some new positions initiated during the second quarter included[3]: Global Blood Therapeutics; Great Bear Royalties; Sierra Wireless; Hill International; Avalara Inc; Ping Identity Holdings; and Recipe Unlimited.

SPACs – a lot going on!

New SPAC issuance continued to slow with only eight new IPOs in the third quarter. Through the first three quarters of 2022 there have been 77 SPAC IPOs, a far cry from 447 over the same period last year[4].

The dramatic slowdown in new SPAC issuance is due to more than a few factors: the risk-off market environment, the uncertainty caused by the SEC's proposed rule changes[5] and SPAC redemption rates – the percentage of SPAC common shares redeemed for the cash held in trust – continuing to be high, at over 80%, during the third quarter[6].

A high SPAC redemption rate and a more difficult market for PIPE transactions means less cash retained by the continuing public company at merger close, which, combined with other factors, has likely contributed to the uptick in SPAC liquidations. Recall that SPAC warrants expire worthless in a liquidation scenario, which is why we continue to employ a conservative approach to SPAC warrants, routinely harvesting them post unit split, rather than hoping a deal the market likes will be completed.

SPAC liquidations, which occur when a SPAC does not consummate a deal and returns all of the capital held in trust to investors, totaled 21 during the third quarter, a marked increase over just eight through the first two quarters of the year[4].

We expect the SPAC liquidation trend to continue and even accelerate through the balance of the year. In addition to the factors mentioned above, the United States' new Inflation Reduction Act includes a 1% excise tax on U.S. companies buying back their shares starting on January 1, 2023. While likely not intended to be the case, the excise tax is thought to apply to U.S. SPAC liquidations and redemptions. Prevailing opinion is that SPAC sponsors will be responsible for the tax and not SPAC investors from funds held in trust, however we think liquidations are likely to accelerate before year end in the face of such uncertainty.

We have acted to shift our SPAC exposure accordingly, and we have benefited from identifying and owning some SPACs that have moved to liquidate early. All else being equal, the pulling forward of liquidation dates can be beneficial to a SPAC arbitrageur's annualized returns.

The SPAC liquidation *cliff* is getting closer. Approximately 72% of listed SPACs have liquidation dates prior to the end of Q1 2023[2]. This presents us with an attractive set-up for our systematic and quantitative approach to harvesting SPAC yields.

There is a lot going on in the world of SPACs, and we continue to deploy capital into what we think is a very attractive reward-to-risk set-up. Unlevered SPAC yields are near 7% annualized on average[7] – a return that is backed by short-term government securities (i.e. T-bills) held in trust.

As of September 30, the fund was well-diversified across 122 SPACs.

Looking ahead.

With central bankers continuing to signal additional interest rate hikes ahead, the case for arbitrage remains particularly attractive.

Rising interest rates are a clear negative for bonds, however they can act as a tailwind for arbitrage because of the low duration nature of the strategy due to deals typically completing within 3-6 months. And arbitrage returns are generated by investing in specific and definitive corporate events and transactions – such as the completion of announced mergers and acquisitions, and the redemption or liquidation of SPACs – differentiating the return profile from traditional equities.

Risk management is central to our quantitative, data-centric and disciplined investment process as we deploy capital into the arbitrage opportunity set.

Maintaining a nimble approach is an advantage in terms of both seeking returns and managing risk. We enjoy the flexibility and advantage of investing across the capitalization spectrum, providing us with a larger opportunity set. And while every merger deal is different, we look favourably on certain mid and smaller capitalization transactions in the current environment because regulatory risks are typically lower, and the deal timelines are shorter. Regardless of deal size, we are always focused on transactions that we believe will reach successful completion.

Thank you for your trust and confidence. Please don't hesitate to reach out with any questions.

Sincerely,

Travis Dowle, CFA
President & Fund Manager
Maxam Capital Management Ltd.

[1] Maxam Arbitrage Fund, Class F, net of fees and expenses. Inception date October 1, 2020. Please contact us regarding other series of fund units or visit our website www.maxamcm.com

[2] Maxam internal database.

[3] Notable owned deals successfully closing, and new positions initiated, during the third quarter is not an exhaustive list.

[4] Source: https://spacinsider.com/2022/10/03/third-quarter-2022-spac-ipo-review/

[5] We discussed the SEC's proposed rule changes for SPACs in our Q1 commentary: www.maxamcm.com/maxam-arbitrage-fund-q1-2022/

[6] ICR SPAC Market Update and Outlook, Q3 2022.

[7] Maxam internal database and https://spacinsider.com/stats/