Maxam Arbitrage Fund – Q4 2022 Commentary

Dear fellow investors,

Equities and bonds faced significant pressure throughout 2022 from high inflation, rising interest rates, supply chain issues, recession fears and ongoing geopolitical tensions. It has been described as one of those "nowhere to hide" years – and was one of the worst years ever for the traditional balanced portfolio, as evidenced by a Bloomberg index tracking a global 60/40 portfolio mix declining -17.0% in 2022[1].

Given the challenging environment, we are pleased that the Maxam Arbitrage Fund had a positive year. Our nimble and systematic approach, bolstered by our risk management focused process, held us in good stead. Moreover, the strategy showed the value it can add to modern diversified portfolios – low risk and diversification via an alternative source of returns.

	2022
Maxam Arbitrage Fund[2]	**+2.0%**
S&P Merger Arbitrage Index	-4.2%
S&P/TSX Composite	-8.7%
S&P/TSX Small Cap	-11.2%
S&P 500	-19.4%
NASDAQ	-33.1%
MSCI World	-17.4%
iShares Core CAD Universe Bond Index ETF	-11.7%
Vanguard Total Bond Market ETF	-13.1%

Source: Maxam, Bloomberg

M&A in 2022: Like a good Netflix drama… a few plot twists, but a happy ending.

It was a challenging year for merger arbitrage as evidenced by the S&P Merger Arbitrage Index declining -4.2%.

In addition to the risk-off capital markets, arbitrage spreads and deal timelines were pressured by the steady rise in interest rates, reduced credit availability for leveraged buyouts, and the increased scrutiny that U.S. and some foreign regulators are applying to select transactions.

Increased regulatory reviews – typically focused on larger cap companies in industries deemed more sensitive to competition concerns – have resulted in some lengthened deal timelines, however success from the regulators' perspective has been mixed. In a positive sign for arbitrageurs, and as we noted in our Q3 commentary, the U.S. Department of Justice lost their attempt to block two transactions: UnitedHealth's acquisition of Change Healthcare, and U.S. Sugar's acquisition of Imperial Sugar.

Meanwhile up here in Canada… although the Rogers Communications acquisition of Shaw Communications has not yet cleared its final hurdle, Canada's Competition Tribunal recently ruled against the Competition Bureau's attempt to block the merger on grounds that it is anti-competitive.

Another much-watched deal in 2022 was Elon Musk's acquisition of social media messaging platform, Twitter. This transaction wasn't notable for any regulatory challenges, but rather for *Elon being Elon*. After reaching an agreement to purchase Twitter for $54.20 per share in April, Musk seemingly had second

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thoughts and sought to back out of the deal, sending a deal termination letter in July. However, Musk had signed a definitive merger agreement that significantly limited his ability to back out – he couldn't simply choose to terminate the transaction by paying a break fee. Musk completed the acquisition of Twitter at the contracted price in late October. Score a victory for contract law.

Despite the challenging environment in 2022, M&A transactions continued to close on terms and, apart from some of the largest cap deals, generally within expected timelines.

State of the arb market.

Existing transactions and new deal announcements during the fourth quarter continued to provide us with a robust opportunity set of attractive deals to arbitrage.

Of note, the risk-free rate can be considered as a component of the arbitrage spread, with arbitrageurs being incrementally compensated for deal risk. Following the steady rise in interest rates throughout 2022, we are seeing higher spreads to deploy capital into today. Arbitrage returns have historically improved when rates have risen – and that is the environment we are in now.

The fund participated in 14 new deals during the quarter, had 32 successful deal closures and experienced one deal break. As of year-end, the fund held 25 merger arbitrage positions, diversified across market cap, deal type and industry.

Owned deals that successfully closed during the quarter included[3]: Avalara Inc; Global Blood Therapeutics; Ping Identity Holding Corp; Recipe Unlimited; Great Bear Resources; Taal Distributed Information Technologies; Hill International; BTRS Holdings; Switch Inc; Turquoise Hill Resources; and Evergreen Gaming.

SPACs: You've got to know when to hold 'em, know when to fold 'em[4].

The fourth quarter of 2022 was a busy one in the SPAC sector with plenty of activity and new developments to manage. Continuing the recent trend, new SPAC issuance was slow in the last quarter of 2022 with only eight, relative to 166 in Q4 2021[5].

In our Q3 commentary we wrote that we expected SPAC liquidations to accelerate through the end of the year due to high SPAC redemption rates, an increasingly difficult market for PIPE financings and uncertainty if the new 1% excise tax on U.S. companies buying back their shares would apply to SPAC liquidations and redemptions.

Undoubtedly concerned with the application of the excise tax, many SPAC sponsors moved to liquidate early. 119 SPACs were liquidated in the fourth quarter, with 87 in December alone – those numbers compare to only 23 liquidations through the first three quarters of 2022[5]. The U.S. Treasury Department and Internal Revenue Service issued guidance[6] on December 27th that SPAC liquidations would not be subject to the excise tax. Welcome news indeed, but a little late for some sponsors.

We were able to complement our systematic SPAC arbitrage process with some success in identifying and owning SPACs that moved to liquidate early. The pulling forward of liquidation dates is beneficial to a SPAC arbitrageur's annualized returns – in that we get capital back sooner and can redeploy into new opportunities.

SPAC redemption rates – the percentage of SPAC common shares redeemed by shareholders for the cash plus interest held in trust – continued to be high during the fourth quarter at an average of 89%, compared to 66% in the last quarter of 2021[5]. High redemption rates and liquidations have wreaked havoc on SPAC warrants – recall that SPAC warrants expire worthless in a liquidation scenario.

We've continued to largely avoid exposure to SPAC warrants, certainly not purchasing them in the recent environment. When we've owned them post unit split, we've acted to harvest their value expediently, rather than *hoping* a deal the market likes might be completed. *Kenny Rogers-style* [4].

And the SPAC liquidation *cliff* continues to creep ever closer. At year end there were 533 listed SPACs, 226 of which have liquidation dates prior to the end of Q1 2023[5]. As their SPAC liquidation dates approach, sponsors are faced with either winding up or extending – if they choose to extend, the sponsor typically offers an incentive to shareholders by topping up the trust account.

The SPAC market environment has evolved significantly over the last few years, but it continues to present us with an attractive set-up for our systematic and quantitative approach to harvesting SPAC yields. And given the current dynamics at play with liquidations, redemptions, and extensions, we also expect some unique opportunities to generate attractive and low risk returns.

As of December 31, the fund was well-diversified across 106 SPACs.

Looking ahead.

2022 was a negative year for almost all strategies, and on that note we are pleased that the Maxam Arbitrage Fund was able to demonstrate its value as an alternative and non-correlated source of returns.

While we believe we are likely closer to the end of this rate hiking cycle than we are to the beginning, central bankers continue to signal additional interest rate hikes ahead. Rising interest rates are a clear negative for bonds, and broadly a headwind for equities, however higher rates can be a positive for arbitrage investors.

Arbitrage is a low duration strategy due to deals typically completing within 3-6 months, which allows an arbitrageur to reinvest deal proceeds into new attractive transactions. And, as mentioned above, higher interest rates lead to higher arbitrage spreads.

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.

Risk management is central to our quantitative, data-centric and disciplined investment process as we deploy capital into the arbitrage opportunity set. We are excited about capitalizing on opportunities in the current environment and the year ahead.

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]Bloomberg Global EQ:FI 60:40 Index is designed to measure cross-asset market performance globally. The index rebalances monthly to 60% equities and 40% fixed income. The equities and fixed income are represented by Bloomberg Developed Markets Large & Mid Cap Total Return Index (DMTR) and Bloomberg Global Aggregate Index (LEGATRUU) respectively. (BMADM64 Index).

[2] 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

[3] Notable owned deals successfully closing during the fourth quarter is not an exhaustive list.

[4] The Gambler, by Kenny Rogers – it's a famous song, check it out. Merger and SPAC arbitrage isn't about gambling; it's about capitalizing on specific and definitive corporate actions and events. But you do have to know when to hold 'em, and when to fold 'em, because prices and opportunities change. https://en.wikipedia.org/wiki/The_Gambler_(song)

[5] Source: SPAC Research - Year in Review : 2022. https://www.spacresearch.com/

[6] https://www.irs.gov/newsroom/treasury-irs-issue-guidance-on-corporate-stock-repurchase-excise-tax-in-advance-of-forthcoming-regulations

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