



ARENA
INVESTORS LP

April 2020

“If trouble comes when you least expect it then maybe the thing to do is to always expect it.” — Cormac McCarthy

I hope you and your loved ones are faring well and staying safe in this pandemic.

In early March, I sent you some of our initial thoughts on COVID in the context of it potentially being the “market surprise” that could lead to a significant re-pricing of risk. Also included was a broader discussion on the structure of Arena as a global chaser of illiquidity – with the infrastructure, process and people to be able to source opportunities with great flexibility, identify through comparison those that are clearly compelling and those that are not, and manage the end-to-end process for running what is effectively a “non-bank bank”. That letter was followed with some of my initial thoughts on the preliminary range of possibilities the virus might present.

In many instances, we believe this re-pricing of risk has already happened, and it is likely to occur in many more. It is likely that “whatever it takes” for global monetary authorities and governments would have been ultimately necessary given the severity of the pandemic. However, perhaps it had to be the first tool used because a decade of artificial rate suppression had left no other tools in the toolbox in addition to creating a massive asset and credit bubble the likes of which the world has never seen. In our view, there has been a level of currency debasement on a global scale that has rarely, if ever, occurred. The repercussions of this are difficult to predict, but any reasonable reading of economic history suggests they are daunting.

We wanted to now send you a more granular update on our current investments and how we are seeing the opportunity landscape moving forward.

As a reminder, Arena is constructed to source, underwrite and manage opportunities where we are compensated not based on having a differentiated view on value but, rather, we are paid to be a provider of liquidity in situations where we are assuming “process risk” in structures that are secured either by assets readily able to be liquified or by businesses that are highly free cashflow generative with protected franchises that can withstand turbulence. Our investments feature high levels of downside protection (a 66% loan-to-value on average which gives us 34% cushion of value to absorb losses), strong covenants (*e.g.*, monthly coupon and monthly reporting), and are generally also senior-secured with relatively short duration (with the current average remaining duration for our illiquid investments at 2.0 years).

Our goal is to then construct a portfolio of those investments that is as uncorrelated to the overall market as possible, which we seek to accomplish by avoiding or hedging explicit macro exposure (*e.g.*, interest rates, currencies, commodities), by having a large number of positions (our average position is currently 1.2%, which also provides downside protection against idiosyncratic losses), and also being diversified in terms of limiting our exposure to semi-systematic risk factors (*e.g.*, groupings of positions that should be unrelated to each other, but could be related based on a common risk factor such as a particular geography or being in related industries). As part of the process, for each position we ask ourselves, “How will this prospective investment fare during the next October 2008?” And if the answer is “badly,” we will avoid it.

Further, we stress alignment in everything we do – including insisting employees, joint venture partners and other relevant stakeholders have skin in the game. Finally, all of our investment vehicles are asset-liability matched, we provided virtually no “open” revolvers where our capital can be called, and we employ no recourse leverage on illiquid assets.

If all of these elements are diligently adhered to, we should have a portfolio that can achieve significant returns while withstanding as great a variety of unexpected negative events as possible. Through the integrated efforts of our asset servicing unit, Quaestor Advisors, LLC, and our front and back-office employees, we have been checking the health of our partners, borrowers and counterparties, and offering our assistance in cases where we can be helpful.

Our end-to-end process is completely systematized, and those processes are hardwired into our proprietary IT systems. While it is never ideal to be working remotely, our infrastructure was already designed to handle the current remote working environment.

Having said all that, what I said one month ago remains true – we are as comfortable with the portfolio today as we were before the virus, and we continue to see ample value creation opportunities from our current investments.

To be clear, that is not to say that every investment we make (virus or no virus) will turn out exactly as we expect – that is the main reason we structure the investments and the portfolio’s diversity the way we do. And that is also not to say that we have not made investments that have been affected by the virus. In certain instances, we had positions for which the prospects were materially changed by this new environment. For example, we have a \$4 million position in a restaurant chain for which we also provide merchant credit card processing that remains current but which now requires added attention. Also, we had a \$1.8 million aviation position with a very skilled joint venture partner where their capital was subordinate to us that will likely result in a small loss at the asset level, but it will be cross-collateralized with further opportunistic investments in adjacent areas with the same partner. However, in many cases where we chose to reduce values it was due to a potential for delay or decrease in cash flow streams versus crystallized losses.

While health and safety are paramount, the virus has also created upside opportunities in many of our investments. Examples include: (i) a ~\$10 million position (including 15% equity ownership through warrants) in an addiction recovery clinic where local hospitals are referring them detox patients in order to provide their beds for other cases; (ii) a ~\$16.6 million loan that includes 40% equity participation (at a 55% discount to fair market value at inception) to a company that engages in quality control and testing for semiconductor companies that now has adjacent opportunities to expand into doing similar certifications for the biopharma industry; and (iii) our joint venture that factors online receivables from companies like Google and Amazon that are payable to small business owners (which, like most of our relationships is structured as a “fishing pole” where we advance small amounts and then re-underwrite each incremental add-on) where the current environment is producing even more favorable rates on such advances.

We have not yet seen any meaningful shift in our taking control of situations. We are now in the process of taking ownership of three underlying assets and businesses, but all of those were likely to occur well before the virus. We are more than prepared to do so, and this has been return-enhancing given our favorable loan-to-values and our operational capabilities and capacity to manage those situations. As described in our January update, we have also added to that capability set, with the addition of Quaestor Strategic Advisors,

which gives us the capacity and capability to further enhance value creation in situations where we take control.

And in total, for your capital and ours (which is invested alongside you), we are pleased that the current market stress-test has worked the way we would have anticipated, and having invested through several similar downturns in 1998, 2001-2002, and 2008, that our gameplan for preparing to do so was based on experience (and not theoretical).

Looking forward, we continue to attract new capital from investors to deploy. And as you know, Arena is set-up as an enterprise to be able to scan across the world of asset and yield-oriented investments, to identify where the relative risk/reward is favorable. As we do that, we see incrementally more opportunities today, these opportunities are on average larger, and we anticipate more to follow.

We are grouping those opportunities into four buckets:

- 1) Bucket one is what we refer to as “short-term dollar bills on the floor”. In the midst of the selling and forced selling by investors and investment funds in the panic, we saw opportunities where a combination of risk/return, duration and liquidity were presenting very compelling short-term opportunities without extinguishing our option to deploy in less liquid situation depending on later changes in the market. As one example (that we were able to do a few small trades in)– special purpose acquisition companies (SPACs) that raise money to do acquisitions, but have to keep that money in a separate trust invested in Treasuries, and where the holders can take their proceeds back if they ultimately decline to participate in the proposed acquisition. During the sell-off, there were situations where we were finding SPACs trading at 10-15% annualized returns to the trusts’ holdings. Though the spreads on these types of opportunities have now narrowed, our ability to move across public and private markets leaves us positioned to bite at these opportunities when they present themselves. If the markets retrace as they have after many other post-crash rebounds, we would expect to do more in these situations.
- 2) While not an opportunity we have taken advantage of to date, in the world of other tradeable paper – including leveraged loans, ABS, and mortgage securities – we were monitoring the landscape during the sell-off, but did not see levels that, to us, were more than 1/3 to 1/2 of the way to the level at which we would find them compelling (particularly given the evolution of worsening underlying collateral, longer duration, etc.). But as in the previous bucket, our teams are set-up for opportunities here, and this whole universe could see quite another downturn should some of my observations play out regarding the over-use of structural (and recourse) leverage, asset-liability mismatched investment vehicles that will need liquidity and the delayed reporting of the effects the virus has had on structured finance assets and middle market companies.
- 3) In privately negotiated bilateral transactions (including the purchase of existing obligations), we are immediately able to re-price for COVID conditions in new investments we are considering. For many situations in which we have already been involved, we were already pricing to a 2008-level. However, today we are also seeing emerging opportunities in areas that were previously more on the side of the spectrum of being “priced to perfection” where we can now apply “2020 post-virus-pricing”. The areas here that interest us the most are those that are inherently independent of the cycle (or virus), but this dynamic is starting to flow into many areas of privately negotiated transactions. These range from corporate loans where banks and BDCs have vanished and commercial mortgages where lender warehouse lines have been withdrawn to structured finance assets where over-aggressive hedge funds

have had to recede. Several examples of this are also found in our structured private convertibles business, where we now have extensive infrastructure and capabilities globally, and find ourselves working with a great number of larger public companies than we have yet seen.

- 4) Then there are areas that actually did experience permanent damage as a result of the virus, and where we have decades of experience and extensive partnerships and infrastructure or where the virus has created a geometrically greater need for our capital. An example of the former is in aviation, where the current dynamics present one of the most compelling investment environments since 2001 when I first got involved, having hired a banker from the US Treasury Department who had been focused on the airline bailouts and spending a year of intensive research in the space. This led to some of our earliest joint ventures, like Apollo Aviation, which was ultimately acquired and is now Carlyle Aviation Partners and managing \$6.6 billion. Even before COVID-19, there was a wave of airline failures as a result of overcapacity and high operating costs, and now COVID-19 has upended the sector with a massive grounding of airplane fleets and the probability that a large percentage of older widebody aircraft types like the A340, 777, A330 are likely to be permanently retired. Airlines and lessors are desperately seeking to raise liquidity from asset sales and sale lease-backs and many are not going to survive despite significant government assistance.

We believe Arena currently has no legacy exposure/overhang from the previous “boom” years of the past decade and was not engaged with airlines or lessors on transactions like 4+ year leveraged leases that were wildly over-financed (which will now face a day of reckoning). And Arena has experience across the entire value-chain of securities (including ABS, EETCs, and corporates), airplane and engine leasing, part-outs and part-sales of end-of-life aircraft and other aviation assets, cargo conversions and helicopters.

Another example of this is in oil and gas credit, where producers (across all levels of market capitalization) are navigating a crisis as capital flees the sector – creating distress (on top of a situation that was already facing material distress when we re-entered the space about 3 years ago). The recent price swings have again incapacitated those that took implicit price bets, the banks continue to stay away, “Fossil Fuels” are only increasingly being red-lined by institutional investors, and there is a “private equity apocalypse” among the firms that bought large amounts of land for development, as many in the industry believed that “unconventional shale” was a once-in-a-lifetime land grab, but an unprecedented increase in the efficiency of fracking has reversed that notion of scarcity. The extreme recent volatility globally and among international suppliers will only increase our ability to finance and purchase assets inexpensively while hedging away commodity price exposure.

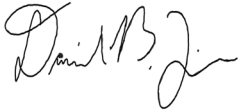
Finally, there are areas where we are also particularly positioned well to play “offense”. For example, our business providing residential construction loans in New Zealand backed by the New Zealand government continues to thrive. We have been well-positioned in that space for the last three years, and the government’s economic response to the pandemic is to increase their commitment to real estate development as a way to jump-start the economy and also address the nearly one hundred thousand unit housing shortage that exists in and around Auckland.

This is of course just a broad brush and small sampling of what we are focusing on, and what we are continuing to force rank as we recycle and deploy new capital. Given our mandate flexibility and cohesive design (*i.e.*, Arena is not made up of separate teams – it is one integrated unit), we see a lot of opportunity ahead. We continue to do what we have been doing for the last five years, which is to build and refine our

enterprise and its processes, having no obligation to *have* to do anything. We dispassionately assess what is available, and stay disciplined in our requirements, assessments, risk controls, and oversight.

Again, I hope you are well, and please stay safe and healthy during these times.

Best Regards,

A handwritten signature in black ink, appearing to read "Dan Zwirn". The signature is fluid and cursive, with a large initial "D" and a long, sweeping tail.

Dan Zwirn
CEO and CIO

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