ARENA
INVESTORS LP

To: Investors and Interested Parties

From: Arena Investor Relations

Date: October 19, 2017

Re: Third Quarter 2017 Update
Arena Special Opportunities Fund, LP

A Message from Our Founder

About three weeks ago I was asked to speak at a conference and address the private credit space, specifically whether or not there is a private lending bubble. Two weeks prior to that, I attended a separate engagement where I was asked to discuss the state of the credit markets, particularly the current credit cycle. A number of recent headlines have highlighted the private lending space and the overabundance of capital flowing into the asset class. Evidently, the credit markets and whether or not we are caught within a bubble is top-of-mind for investors. I thought I would share some thoughts.

To start, is there a bubble or not? There is.

There is an incredible amount of private equity, credit and real estate capital available in the market. It has been nine years since we went through the 2008 crisis, and there are many different sectors and asset classes that have yet to fully recover. Many investors learned the wrong lessons from the crisis and provided capital in new areas, ways or structures that were imprudent. New ratings agencies have emerged since the crisis, and clever market participants appear to be playing games "arbitraging" the ratings they can get from these secondary agencies. Banks have diminished their lending activities though they have invested heavily in credit-related securities. This has enabled them to build their yield portfolios, assert to regulators that they are being highly conservative in their lending books, and simultaneously convey to shareholders that they can get appropriate returns on their equity.

In private credit, we generally see and avoid connections to the liquid trading markets. This is particularly the case in middle market corporate lending, which most investors have in-mind when referring to "private credit" or "direct lending." The level of excess across different asset classes has peaked relative to the last 25 years, and the markets across corporate, asset-backed securities, mortgages and emerging markets are at tighter levels relative to collateral quality than they have ever been over that time period. The situation now is even worse because collateral credit quality has deteriorated and is being masked in a variety of ways. Further, the "liquid credit" markets themselves do not have the liquidity that people presume them

to have, given the decline in OTC market making and regulator overreach resulting from the Volker Rule. When I started my career, there were only two other alternative firms that did what we called at the time "special situation private lending." The fact that "private credit" and "direct lending" have become defined terms in the alternative space should in itself be a cause for alarm; once things become something that everyone does, we pause and get concerned. Where is the "alternative" in that?

What can cause the bubble to rupture? Certainly there is no shortage of candidates whether from geopolitical instability, a large scale corporate fraud, issues within the structure of the ETF market, or a step-function drop in the performance of collateral types. Residential mortgages were absurdly overpriced in 2007, but so were a number of other credit markets. Even though this area happened to be the place where the fire started, it could have started with many others. The fundamental reason that credit investments implode is because of the disconnect between the assumption of credit risk and responsibility for its consequences. We can look back to the residential mortgage crisis and observe that those who were originating loans were paid to originate, not to make good loans that were repaid. Time and time again, we see that people who are in the position of originating loans of all types are detached from the consequences of those bad investments.

When done correctly, private credit can be complementary to relatively conventional alternative investment management portfolios or institutional or endowment portfolios. However, it takes much more work in a benign credit environment, and you have to know where the bodies are buried. Acknowledging that we are in a bubble and mitigating the risks associated with it creates a number of short and medium term opportunities within the corporate private credit, real estate, and structured finance spectrum upon which we continue to capitalize.

When we see a corporate credit opportunity, our first question is "why wouldn't a BDC or middle market lender do this?" If they will, then we have no interest. We seek differentiated opportunities, whether it involves a tough industry, accelerated process or a perceived-but-not-"real" regulatory issue. In short, if there is no "wrinkle," then there is no opportunity or means of charging a premium.

In real estate credit, it is ideal to have lending situations that are net income-producing, have relatively straightforward buildings, and feature advance rates of 65% LTV. However, we often find that while loans against assets may appear to be of the highest quality at first glance, such loans are some of the scariest investments to consider on a risk-adjusted basis. In fact, the very same assets that might "scare" conventional lenders tend to present us with superior opportunities on a risk-adjusted basis. We seek out these assets, and continue to capitalize on those where there is "process" not "value" risk.

Lastly, structured finance, including more broadly commercial and industrial (C&I) and consumer assets, is where we spend a large portion of our time. It is in this area- unlike in middle market leveraged lending- where banks really did go away and may not return. When you consider the capital attribution necessary from the perspective of either the U.S. banking rules or Basel bank capital regulations, these transactions cannot earn adequate returns for banks. There are places within leasing, logistics finance, and trade finance where we can access first lien financing from regular way bank participants that lend inexpensively against assets with very low correlation to the overall markets. Within consumer assets, investment opportunities

including residential mortgages, subprime auto, charged-off credit, and student loans can pay big rewards if one has the infrastructure, resources and expertise to assume the risk.

To reiterate, when private credit is done correctly, it can be a compelling asset class that complements the construction of a broader institutional portfolio. We continue to seek, source, analyze, and service a great number of smaller and mid-sized opportunities that have a wrinkle. These opportunities require a lot of hard work; however, they have proved to be accretive to our overall strategy. Wherever there are opportunities for disproportionate return per unit of risk, we want to be there.

All the best,

Dan Zwirn