

March 17th, 2020

Dear Investors,

In these unprecedented times, above all, I trust that you are all in good health, taking utmost care of your loved ones. On behalf of the Chenavari team, I sincerely would like to extend my very best wishes to you and your families. The coronavirus pandemic is undoubtedly frightening, as we are in unknown territory: this crisis requires our highly *sociable* and *mobile* society to suddenly implement *social-distancing* and *travel bans*. As a custodian of part of the capital that you have entrusted us with, I wanted to personally update you with our current views on the credit markets, as the global economy has now entered uncharted territory.

As elements of reference, we have attached to this letter an update on various relevant market levels (as of yesterday), in which exacerbated volatility is apparent across the asset-classes.

As you may recall from our most recent annual letters and previous investor communication (see footnote below ¹ as well as on our website www.chenavari.com), we at Chenavari Investment Managers have not been shy highlighting that valuations in both credit and equity markets appeared excessive. **As a firm, we have been expecting credit spreads to widen for some time now due to both fundamental parameters including increased leverage in the corporate sector in particular, and worrying “technical” (thin liquidity, growing asset-liability mismatches) that could lead to major dislocations, especially in the credit markets.**

It is worth highlighting how the above-mentioned investment convictions have obviously influenced our investment strategies and product offering over the past few years, in particular:

- In the past two years, we have been running an absolute return derivative strategy seeking to benefit from a possible widening of credit spreads. This strategy has been predominantly implemented in an investment vehicle (dubbed “DCC” after the expected change of credit cycle) managed by my partner Fred Couderc, also Chenavari Co-CIO. It has performed strongly since the beginning of 2020, up estimated circa 94% net year-to-date as of March 16th ².
- In the other most liquid credit hedge fund, namely the Lyxor Chenavari UCITS Credit Fund, we also implemented our conservative views on the credit cycle, keeping a neutral spread sensitivity. As a consequence, the fund’s performance is slightly up year-to-date³.

¹ January 30th 2020 - Annual Investor Letter

<https://www.chenavari.com/assets/Uploads/7b31d81c97/Chenavari-Investment-Managers-Annual-Investor-Letter-2020-EXTERNAL.pdf>

June 28th 2019 - Investor Communication – When will this stop?

<https://www.chenavari.com/assets/Uploads/4c38bbdafa/Market-Commentary-on-QE-Liquidity-and>Returns-v2.pdf>

Annual Investor Letter – January 28th 2019

<https://www.chenavari.com/assets/Uploads/cbc376f6a2/Chenavari-Investment-Managers-Annual-Investor-Letter-January-2019-EXTERNAL.pdf>

Annual Investor Letter – February 15th 2018

<https://www.chenavari.com/assets/Uploads/08ff828a1d/Chenavari-Investment-Managers-Investor-Letter-A-New-Regime-for-Global-Markets-15-February-2018-1.pdf>

² Source: Chenavari unaudited estimate

³ Source: Chenavari unaudited estimate

- More generally, across our mandates, tradable credit positions have been limited in size, with a neutral profile and focused primarily on bonds with subordination and/or a significant fundamental cushion. E.g. on European AT1, the European banks' subordinated debt, the remainder of the long risk financial bond positions were sold in early February this year: these bonds trade today c.35pts lower on average.
- Finally, over the past few years, we recommended to our investors, especially those who had the ability to take exposure to less liquid funds, to focus the bulk of their capital on the European private credit space. This is where we identified attractive sources of alpha, especially in the less crowded part of the specialty finance market. In the past few years, the Chenavari private credit teams originated close to 10bn Euros of private credit loans, either directly or through specialty finance partners or via acquisitions of performing loan portfolios from banks: in total, circa 4.1bn Euros of investors' capital was invested in European private credit strategies, predominantly in asset-backed private loans. Having tangible assets and/or highly granular excess cash flows as collateral to the private credit exposure has been a requirement to our investment thesis, thus avoiding common exposure to sponsor-backed direct lending investments.

What is our current assessment of the situation and are there opportunities to grasp from here?

- In our view, this terrible pandemic due to the COVID-19 outbreak is undoubtedly triggering an **event-driven recession**. In turn, it is **likely to lead to a global cyclical recession**.
- This recessionary environment will **expose the many weaknesses of the credit markets**.
- I first believe **we should all be humble**, given that the peak of the crisis has not been reached in either Continental Europe or the US, where the lock-down is just starting.
- Current prices may exhibit some value, as the markets have corrected sharply since the beginning of March.
- However, **what is cheap is not necessarily good value**. There are primarily two main reasons for which I urge caution:
 - **First, technicals.** We have not yet seen significant outflows and fund deleveraging. Banks have started to call funds on margin calls and unilaterally increased haircut requirements on levered positions (e.g. a large European investment bank on AAA ABS 1-month repo previously offered a 8% haircut at minus 5bps up to last week, it moved to 20% haircut with a 2% financing cost this week). Fund outflows are only just starting and will be triggered by the likely redemptions in the forthcoming weeks. In other words, some funds, in our opinion, have been *“driving too fast on the motorway”* over the past few years, taking long positions with large amounts of leverage on tight credit spreads. These funds will now be forced to reduce their exposure either by the banks, or simply because their investors are likely to redeem.

- **Second, fundamentals.** It is extremely difficult at this stage to perform reasonable and credible fundamental work on idiosyncratic exposures. How long will this outbreak last? What will be the consequences of the “*economic stop*” on companies’ earnings, balance-sheet and free cash flows? What will be the measures taken by governments/central banks to compensate for the losses of the corporate sector? Will the companies be able to sustain the negative free cash flows over a long period where their activity will slow down/stop completely? Some bond prices may look attractive (as said earlier, most bonds are trading 30 to 40% lower than a month ago). I believe we may need more time (a month or two) and insight on the fundamental impact of this crisis on the individual finances of each company to establish a strong fundamental-validated value investment conviction.
- Notwithstanding the above explanation, **dislocation creates opportunities.** In these unprecedented times, there are already some, and there will be many more opportunities in the months to come, where **our objective is to “lock-in” exceptionally attractive risk-adjusted credit spread.** We need to be ready to grasp these opportunities:
 - **Current opportunities** (not exposed to “fundamental unknowns”): there are two main “focus areas” where we see value currently and we are very selectively considering adding long risk, in the right investment vehicle (i.e. not constrained by short-term redemption risk):
 - **Structured credit/structured finance credit exposures with no/remote default risk:** In other words, provided the value is attractive, we would selectively go long risk on ABS/Structured Credit with a subordination buffer large enough so that it would allow us to deal with the “unknown territory” we were alluding to earlier when assessing the ability of companies to avoid defaulting. Such opportunities can currently be sourced with very attractive yields. These do need to be well structured (term leverage, if any, or fund vehicle with suitable liquidity) and with the ability to manage possible marked to market volatility.
 - **Highly collateralised short-term private loans:** as an illustration, in the current environment over the past two weeks, we have been approached by several cash-stressed high-credit rating corporates (in one instance, with an explicit state guarantee) and also by single family offices looking for short-term loans for sudden liquidity needs. For example, up to a month ago, large private banking clients were heavily invested in illiquid assets such as private equity, real estate, illiquid funds, and the majority of them also still had a portfolio of stocks invested with cheap leverage provided by their private bank. In normal times, this leverage is relatively normal. However, in the current environment, the private banks are sending margin calls and some of these family offices are looking for liquidity solutions. These unusual times provide select opportunities to be thoroughly due-diligenced in order to structure highly collateralised short-term bridge loans at increasingly attractive rates, as the traditional banks are not stepping in during these complicated times.

- In the coming weeks/months, **fundamentally-driven idiosyncratic credit opportunities will arise** (beyond the “no default-risk” current opportunities). The “unknown” environment is expected to last for some time, as the peak of the virus outbreak is expected mid-May in Europe and possibly later in June in the United States. **Once the worst is over, our specialist teams will be ready to grasp these fundamentally-driven opportunities**, either through single name credit exposures or ABS bonds in the lower part of the capital structure. At this stage, we will be in a better position to assess the specific financial situation/solvency of each corporate (with our fundamental research) or underlying loan portfolios with our ABS analytics. **The Chenavari team - 92 professionals focusing on Credit, Structured Finance and Private Credit in Europe - has a proven track-record⁴ in this market environment** and intends to leverage on its extensive capabilities across the liquidity spectrum of European credit markets to deliver attractive absolute returns for investors.
- The **Chenavari Core** open-ended investment vehicle is being specifically structured with a liquidity profile that we view suitable to take advantage of the above-mentioned dislocations in our markets, with a focus on opportunistic tradable credit and short-duration private credit loans.

Above all in these unprecedented times, I wish you and your families stay healthy and positive. A calm, reasonable and orderly approach to these unfortunate circumstances is the only way forward.

Kind regards,

Loïc Fery, CEO & Co-CIO

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Should you wish to arrange a follow-up discussion, please do not hesitate to contact:

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⁴ Cf. The track record of our European ABS hedge fund - Chenavari Toro Fund between its inception (June 2009) to the date at which it was turned into a listed vehicle (May 2015)

<https://chenavaritoroincomefund.com/assets/Uploads/348667c90a/2015-Q2-Factsheet-May.pdf>