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Arena Investors' niche global deals bring returns, inflows

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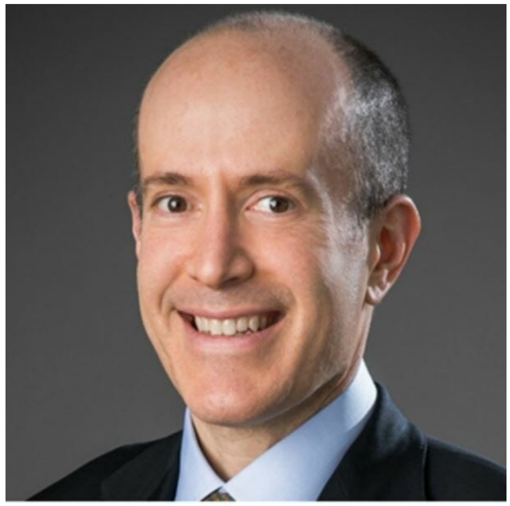

Daniel Zwirn can take a punch. In 2009, the multi-billion dollar credit hedge fund he founded was beset by a federal investigation after a series of improper fund transfers by its chief financial officer. It took three years before the Securities and Exchange Commission would complete its investigation of Zwirn and his company D.B. Zwirn & Co. The CFO, Perry Gruss, was eventually convicted for "knowing misuse" of client funds. The firm returned all investor capital and closed. "I learned that anything can happen, no matter how good your auditor is and how many reference checks are done," Zwirn says.

Fast forward to 2019 and Zwirn is back on track. He is the founder of New York-based Arena Investors whose flagship strategy focuses on small credit-enhanced deals sourced through a network of partners. Whether it's a structured loan for a real estate deal in Brooklyn or an energy company's funding for a hostile takeover that no bank wants to value, Arena is structuring transactions faster than the competition, according to clients.

In a world of compressed fees, where investors know to negotiate for better terms despite the rising costs of running an investment management business, high levels of specialization can sometimes allow firms to prove their worth. In Arena's case, investors still pay the full 2% management fee and 20% performance charge. Justifying the 2/20 fees, Arena has sought to create a niche for itself with its 'go anywhere' agnostic credit capabilities below the focus of most banks.

"We are managing a portfolio that is as diverse as possible," Zwirn says. "For instance, my residential mortgages won't correlate with my European sports team investment (AC Milan) or convertible bond arbitrage positions."

Zwirn believes the credit market is at its 25-year peak, which is why he likes to structure his own deals. "I would love to buy from the public market, but it's too expensive for our fund," he says. Arena's strategy is to originate deals where they can dictate credit cushions and repayments. A handful of caveats for Arena to buy assets include a willingness hold to maturity and a place ahead of other lenders awaiting repayment.

Arena seeks opportunities that are typically below $50 million. The firm's in-house investment team, led by six managing directors, identify the opportunities within six asset classes: corporate, real estate, commercial and industrial, structured finance, consumer assets and corporate securities.

The firm expects compensation for its risk-taking to deliver a 10% area return on average. It seeks to avoid macro risks, such as currency, commodities, interest rates and concentrations, by limiting individual investment exposure to less than 3% of the flagship fund's net asset value. The use of proprietary systems allows the team to organize positions into a common framework for due diligence and servicing.

The hedge fund has acquired 129 illiquid investments since its launch in 2015. At year-end, it held 88 predominantly first lien, short duration positions with an average internal rate of return of 16.7%.

The fund typically holds 1.5-year duration assets, with each month generating a run-off of roughly $55 million. Rather than waiting for domestic bargains to magically appear where they might redeploy capital, the Arena investment teams look further afield including to Greece, Italy, Australia and Puerto Rico for bargains.

Screening deals

Arena believes memo writing, sometimes exceeding 100-pages, is fundamental to sound purchases. Identification and sourcing opportunities are made by the front office team, direct relationships and joint venture partners. Screening investments typically takes two to four weeks and involves the chief investment officer, Zwirn, and the head of asset management, John Felletter, from Arbor Realty Trust. For an investment to get a due diligence review the CIO consults with the chief operating officer, Lawrence Cutler, and relevant experts, to approve. After due diligence, the final proposal is presented to the investment committee and the CIO decides whether or not to approve the transaction.

Since launch in October 2015, Arena Investments has returned an annualized 8.3% compared to 5.85% for the Absolute Return Credit Index. Last year the fund earned 8% compared to the 3.1% for the Absolute Return Credit Index. The prior year, 2017 was the first the fund was fully invested, returning 15.7% compared to 7.4% for the index.

JV team and 10,000 deals

The firm's joint venture partners are sector specialists that pitch new co-investment deals to Arena. The JVs get by paid typically at the completion of a transaction in the payment waterfall below the hedge fund. "About two-thirds of Arena's investments use our JVs, and it's about one-third of the roughly $1 billion assets under management we put to work," says Parag Shah, Arena's head of marketing, who joined in 2018 from Bridgewater. Arena managed 50 JV partners in 2018 that fed 10,000 deals into its pipeline review with issues ranging from energy to real estate. Sixty-seven passed Arena's investment committee last year.

"I don't think Zwirn has a better deal sense than anyone," said JV partner Sanford S. Herrick, founder and managing principal at Case Real Estate Capital in New Jersey, who has been executing deals with Zwirn for 15-years.

"I just think he acts on his sense very quickly. His teams are responsive, and do what they promise." Case has earned 15-20% per year unlevered over the past 15-years working with Zwirn, Herrick said.

Case and Arena plan to close a real-estate transaction this month for a $6 million position that should yield a double-digit return with a 1.5-year duration.

One Arena client that has become a JV partner is St. Louis-based Ashley Energy. "In 2016 Arena stepped-in with a structured credit loan to finance a hostile takeover of a competitor that no bank would evaluate," says Ashley chief executive officer Mason L. Miller. Arena evaluated and structured a loan for roughly 13%. After Arena did the work banks came back to refinance at 6% after six months, says Miller.

Ownership and AuM

Westaim Corporation, a Canadian property and casualty company, owns 51% of Arena Investors, with Zwirn and employees holding the other 49%. Once Arena reaches $5 billion in assets, ownership roughly will go to approximately 75% Zwirn and employees, with the remaining 25% to Westaim.

Since launching in 2015, assets have grown to more than $1 billion from an initial $200 million seed investment from Westaim.

"For a credit shop to prove its skill without going through an economic downturn is very hard," said the CEO of New York-based hedge fund consultancy Cliffwater, who oversees all investment research. "Yield and capital raising aren't a good measure of the firm's long term strength for potential investors, underwriting capability and limiting impairments is the key component."

Current portfolio

The firm's in-house investment team has selected most of its credit portfolio in three North American asset groups: 32% commercial and industrial, 25% corporate and 18% real estate as of December 31, with the rest in consumer and structured finance.

Commercial and industrial loans include a handful of aviation deals backed by assets, such as aircraft and parts. One unique deal has Arena financing a Nicholas Cage feature film secured by distribution rights. The firm also made a discounted purchase of performing and non-performing assets from the Puerto Rican Bank of Economic Development in conjunction with a JV partner.

The firm avoids "anything that resembles middle market corporate lending" that it believes is rich with an estimated average of 6x debt/EBITDA. The firm made eight corporate buys in-line with an average 3.6x target amount of leverage.

Representative corporate loans in the flagship portfolio specifically target low leverage and strong cash flow opportunities. For instance, an investment in a company producing low-cost hospital products in a non-invasive format at 5x. A global apparel designer and marketer of lifestyle, headwear and accessories at 1.6x. And a loan to the largest architectural and engineering firm in Puerto Rico, earning two-thirds of its revenue off-Island, at 2.2x.

The real estate portfolio consists of loans secured by hotels, retail stores to multi-family properties. A handful of specific loans exposures are hotels, such as a 5-star hotel in Venice, and properties in Sun Valley, Hollywood, California; Neptune Beach, Florida. Also, a portfolio of multifamily properties in South Chicago to office buildings in Los Angeles and Chicago is held.

"Arena has been running for three years allowing us to source a portfolio with a simple principle of 'lending a nickel against a dime' or 'buying a dime for a nickel,' says Zwirn.
