Arquitos
CAPITAL MANAGEMENT

July 29, 2020

Research is formalized curiosity. It is poking and prying with a purpose.
- Zora Neale Hurston

Dear Partner:

Arquitos returned -7.6% net of fees in the second quarter of 2020, bringing the year-to-date return to -25.2%. Please see page six for more detailed performance information.

The portfolio from the past few years has demonstrated the perils of concentrated investing. From launch in April 2012 through the end of 2017, we compounded the portfolio at nearly 43% per year on a gross basis. A $100,000 investment turned into $768,660 in a little less than six years. Since then, the portfolio has declined by 55%.

My investing skills are neither as good as the first six years nor as bad as the last three years. I have approached research and the management of the portfolio in a similar way. The results, unfortunately, have been very different.

The companies that we own have generally done well over the past three years. The prices of their shares, however, have not done well. Their share prices have gone from being slightly undervalued to, perhaps, fairly valued in late 2017, to extremely undervalued today. A significant portion of the portfolio today trades far below liquidation value. This has caused great pain to the performance of the portfolio.

Ultimately, our positions have been out of favor for several years. Companies with strong balance sheets, smaller companies, and companies that are more boring in nature have been left behind in today's market environment. We generally invest in companies with those characteristics, and our concentration in those positions has exacerbated the negative performance.

There is a flip side to this, of course. This extreme undervaluation provides great promise for performance for the next few years. I will highlight some of our largest holdings below to demonstrate this value. Investing in these safer companies will come back into favor, and we will benefit from that rotation.

In many ways our portfolio is like a private equity portfolio, though we only control one of the companies. The quotational prices at any given time do not reflect the true value of the companies. Monthly reporting isn't ideal in this situation, but as long as we communicate our strategy, investors should understand that we can have wide swings in value over short time periods.

Arquitos Capital Management 15 East 67th Street, 6th Floor New York, NY 10065
Phone: (914) 229-2454 www.arquitos.com

I can certainly moderate my approach to reduce the ups and downs of the portfolio. I don't believe that is in the best interests of our long-term investors, though. Taking a concentrated approach is how I choose to manage my own money, and it is what I do best and am most interested in. It is not a portfolio for everyone. The greatest advantage one can have is a long-term investing horizon. Significant, long-term, outperformance can only happen with a concentrated portfolio. We demonstrated this over the first six years of the fund and will again in the future.

By my estimation, approximately 70% of the Arquitos portfolio trades significantly below liquidation value. What that means is that if those companies themselves decided to liquidate, we would receive gains of more than 50% just from those holdings. Liquidation value is an absolute minimum value for a company, and our companies themselves are worth more than that. But it is worth highlighting to show just how disconnected these valuations currently are.

It seems crazy given the run-up in the overall markets. The markets have left many viable, small, successful companies behind. These companies will come back into favor at some point. When they do, we will likely see significant gains over a short time period.

MMA Capital Holdings (MMAC)
MMA ended the second quarter trading at $23.12. This is a similar price to where shares traded in March 2017.

The company itself has created a tremendous amount of value for shareholders over that time period. Book value stands at $37.59 per share if the company's tax assets are removed. With the tax assets, book value is $47.82 per share. Book value was $20.75 in March 2017. So, book value has grown by 81%, but shares have not moved at all. And the company was not overvalued in March 2017.

Given the nature of the company's operations, book value can be a proxy for liquidation value. In fact, the company continues to hold some off-balance-sheet assets that would likely make its liquidation value even higher if it ever went that route. Of course, it would be a mistake for the company to actually pursue liquidation given the success of its solar lending portfolio, the strong partnerships it has built over the years, the skill of its management team, and its tax assets. The actual value of the company is greater than its book value, but this disconnect demonstrates just how extreme the company's undervaluation is.

This is why MMA has been 40% of the portfolio for several years now. It is an extremely low-risk position given its undervaluation, but it has required patience to hold over the last three and a half years.

The company is currently taking a cautious approach because of COVID. They have not reported any defaults in their loan portfolio, but it remains to be seen how the rest of the year turns out. Even if they do incur some quotational losses in the portfolio, the tax benefits, collateral, high interest rates charged, fees, and short-term duration of the loans should offer significant protection. We'll know more details when the company reports their second-quarter earnings in August.

Even in today's difficult environment—and conservatively accounting for portfolio losses—fair value for the company is at least $35.00 per share, or more than a 50% gain from here. Again, considering that this is 40% of our portfolio, we have considerable potential for significant overall gains in this position alone.

While the short-term stock performance is unknown, I would expect additional clarity from their second-quarter earnings release in August. That release should demonstrate the resiliency of the company to other investors.

Westaim (WED.V)
Westaim has been even more frustrating than MMA. Like MMA, Westaim's book value serves as its approximate liquidation value. Its partnership with the credit fund, Arena Investors, however, is something that would be difficult to replicate by other companies and is likely worth much more than what Westaim carries it at on its balance sheet. Westaim also owns an interest in an insurance company, Houston International Insurance Group.

Westaim shares ended the second quarter at C$2.07 per share. I took the opportunity to buy additional shares recently at C$2.01. I have not been the only one, as insiders have been making large and consistent purchases over the past six months. Book value is C$3.26 per share.

The company has indicated that its insurance subsidiary does not have material exposure to the impacts from COVID. It is also in the process of de-risking its legacy portfolio, having entered into a loss portfolio transfer transaction.

This position makes up approximately 10% of the Arquitos portfolio. Like MMA, conservative estimates would put fair value 50% higher than today's price.

Enterprise Diversified (SYTE)
I have highlighted in the past how Enterprise Diversified has brought the most pain to the portfolio over the past three years. Shares traded for approximately $15.00 per share at the end of 2017. They were down to $2.90 at the end of the first quarter.

Looking back, shares had gotten ahead of themselves a few years ago. They are the exact opposite now. Like MMA and Westaim, Enterprise Diversified's stock trades significantly below its liquidation value which is mostly made up of an investment in Alluvial Fund.

Enterprise Diversified made several significant mistakes with non-asset management investments. Today, we are shedding those parts of the business and focusing on our crown jewel, Willow Oak Asset Management. Willow Oak partners with external investment firms to help them reach their long-term goals.

We recently held a strategy session to help formulate a five-year plan for the company. Everyone associated with the company came away excited about the potential. We'll be releasing additional information on our Willow Oak 2025 Plan over the coming weeks, and we think there is a tremendous opportunity to expand our affiliated manager program.

Currently, Willow Oak has relationships with four affiliated firms. Willow Oak's Fund Management Services handles operations, marketing, back-office, and compliance matters for the fund managers. This allows those fund managers to focus on what they love the most, investing.

In exchange for this enhanced infrastructure, Willow Oak earns a fee share. These relationships are call options for Willow Oak. If the affiliated firms have a great year and/or are able to build their assets under management, both the manager and Willow Oak profit greatly. For the investment manager, this allows them to build significant operational infrastructure, often with no out-of-pocket expense. To learn more about Willow Oak, I encourage you to sign up for their mailing list at willowoakfunds.com.

From an investment perspective, Enterprise Diversified's book value at the end of the first quarter was $3.38 per share. This significantly understates the value of the company for several reasons: our real estate investment is worth much more than what it is held on the books; the internet subsidiary is held on the balance sheet at less than one year of its earnings; the investment in Alluvial appreciated significantly in the second quarter; and the current book value gives no credit to the future earnings power from the fee shares with our existing and future affiliated managers.

I look forward to sharing more about Willow Oak and our Willow Oak 2025 Plan in the coming weeks.

Pendrell (PCOA)

We also have a unique position in a company named Pendrell. Pendrell deregistered from the SEC several years ago and did a reverse stock split to make it more difficult for new shareholders to buy into the company. The current ask to buy a share of stock is $153,000, for example. There are 757 shares currently outstanding, with the company actively buying back shares this year.

Pendrell has significant tax assets and a talented, experienced management team led by telecommunications legend Craig McCaw. Bill Gates is also an owner through one of his investment entities.

Historically, the company collected royalties on intellectual property. Today, they are looking to deploy their cash and take advantage of interesting investment opportunities. Just recently they announced the sponsorship of a special purpose acquisition company, or SPAC. These entities have come back in favor very recently as the IPO market has gotten more difficult.

Sponsors benefit greatly. The SPAC, which recently filed its S-1 registrations statement with the SEC, is named Holicity. This SPAC seeks to raise $250 million. A Pendrell subsidiary would own 20% of Holicity.

Pendrell trades significantly below its liquidation value even without accounting for new investments that it has been making. It has taken a few years, but they now appear to be actively and aggressively looking to create value for the company and shareholders. I am excited to have Arquitos ride along and would be interested in acquiring more shares as our AUM allows. Pendrell is currently a bit more than 10% of our portfolio.

Annual Investor Meeting

We typically hold our investor meeting in September. We are currently looking at holding a virtual meeting this year along with the other Willow Oak-affiliated firms. We look forward to providing a date and additional information shortly.

Thank you for your long-term commitment and support. Though the recent investing environment has been difficult for our strategy, I am excited about the prospects for our holdings. As we've seen this year, things can change very quickly!

Best regards,

Steven L. Kiel

Arquitos Performance Compared to the S&P 500

	Arquitos (Gross)	Arquitos (Net)	S&P 500
2020 YTD	-24.8%	-25.2%	-3.1%
2019	-13.8%	-14.7%	31.5%
2018	-30.6%	-31.3%	-4.4%
2017	80.8%	64.0%	21.8%
2016	65.4%	54.9%	12.0%
2015	-14.0%	-14.8%	1.4%
2014	72.8%	57.8%	13.7%
2013	58.7%	46.6%	32.4%
2012*	9.0%	7.2%	4.9%
Cumulative	246.0%	135.4%	166.3%
Annualized	**16.2%**	**10.9%**	**12.6%**

*Founded April 10, 2012

Disclaimer

This letter is for informational purposes only and does not reflect all of the positions bought, sold, or held by Arquitos Capital Offshore Master, Ltd. or its feeder funds, Arquitos Capital Partners, LP and Arquitos Capital Offshore, Ltd. Any performance data is historical in nature and is not an indication of future results. All investments involve risk, including the loss of principal. We disclaim any duty to provide updates or changes to the information contained in this letter.

Performance returns presented above are for Arquitos Capital Partners, LP and reflect the fund's total return, net of fees and expenses, since its April 10, 2012 inception. They are net of the high water mark and the 20% performance fee, applied after a 4% hurdle, as detailed in the confidential private offering memorandum. Arquitos Capital Offshore, Ltd. was launched on March 1, 2018. Returns from Arquitos Capital Offshore, Ltd. may differ slightly and are not presented here.

Performance returns for 2020 are estimated by our third-party administrator, pending the year-end audit. Actual returns may differ from the returns presented. Positions reflected in this letter do not represent all the positions held, purchased, or sold.

Direct comparisons between the fund's performance and the S&P 500 equity market index are not without limitations. You cannot invest directly into the index. The index may be unmanaged, may be market weighted, and, unlike the fund, the index does not incur fees and expenses.

This letter in no way constitutes an offer or solicitation to buy an interest in Arquitos Capital Partners, LP, Arquitos Capital Offshore, Ltd., or any of Arquitos Capital Management's other funds or affiliates. Such an offer may only be made pursuant to the delivery of an approved confidential private offering memorandum to an investor.