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ZEO QUARTERLY LETTER: 2Q2020

Retail companies don't usually find themselves in the advantageous liquidity position that Tailored Brands, the largest specialty menswear retailer in the United States, had at the start of 2020. Most of the time, both investment grade and high yield companies refinance their maturities as they come due, both in good and bad times. To have more than enough cash and liquidity to fully repay a short-term debt maturity with no other debt coming due for five years is not the norm. Our analysis showed that the company was well positioned to withstand even a 2008-like economic slowdown. Then COVID-19 changed everything in an instant. And on July 1, the company unexpectedly chose not to pay interest on the bonds we hold, thereby starting a 30-day grace period which may lead to the first default in eleven years under our management.

This is not what our clients want or expect from us, and it's not what we want or expect from the companies in our portfolio. We should say up-front that this bond has been fully marked down, so there isn't another shoe to drop if the company does file for bankruptcy. This gives us the opportunity mid-pandemic to approach this discussion with introspection and hindsight, even as we have been actively managing this position and have some limitations on what we can discuss to this point.[1] The situation is evolving and ongoing. We are neither complacent nor resigned to any particular fate.

What follows is a transparent and open reflection of this specific situation; what we have learned so far; and how we are thinking about and positioning in the current environment. While today, we find ourselves explaining an unforeseen casualty of what may be a once-in-a-generation global catastrophe, we still see a dislocation of market prices and fundamentals that is far from over. This pervasive uncertainty presents a unique challenge in what has become an increasingly irreconcilable choice for investors over the last decade: Trade the markets or invest in companies? We continue to do the latter as we always have and have reaffirmed our confidence that the portfolio as a whole is positioned to recover from this isolated event in a single name.

Tailored Brands: Our First Credit Event

Let's get right to the point: How did we find ourselves in this position, and what could we have done differently? To share our thoughts on these questions, we should first provide context. We will begin the discussion by turning back the clock to the start of the year and providing a picture of the credit as it stood prior to the crisis that has unfolded.

We have owned the bonds of Tailored Brands since 2018. As of February 2020, the company had repaid all but $173.4m of the bond's original $599.6m outstanding amount. The management team had a stated goal of retiring the remaining bonds no later than July 2021 and potentially as soon as July 2020[2]. We were in touch with management and had an ongoing dialogue. In our experience, they had established a pattern of being forthright and transparent; appropriately focused on managing their leverage responsibly; and following through on their financial goals, including maintaining liquidity and repaying debt.

1 Readers should note that, at the time of writing, we are temporarily restricted in the issuer, Tailored Brands. The analysis we revisit in this letter is based on public information and company disclosures available to us prior to July 2020.

2 As recently as January, the company appeared to be positioning to do so on July 1, the same day they instead chose to skip the coupon.

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From a business standpoint, their rental business (a staple for proms, weddings and graduations) and their growing custom suiting business (which is difficult to disrupt online) provided a solid fundamental foundation. Meanwhile, the company had been successfully addressing the headwinds caused by the trend toward more casual clothing with sales of non-core businesses; an emphasis on offering more casual options; and a dedicated strategy to build a more robust online presence, an area of particular expertise for the CEO who took over around the time we first entered the position. As a result, the company's recent performance had reversed secular trends and showed growth compared to prior periods to further strengthen cash flows and deleveraging efforts.

As a result, the company had a reasonable level of leverage and ample liquidity heading into 2020. By the end of their most recent fiscal year in February, the company had entered into an agreement to sell assets which would raise $115m and had over $400m of availability on their asset-based revolving credit facility. Notably, the company had explicitly stated their intention to apply the cash proceeds of this sale to further repay their bonds,[3] and the credit agreements explicitly carve out repayment of bonds in the provisions which usually restrict a company's allowable cash outlays.

With this picture in February 2020, one may better understand why we believed the $173.4m of debt which the company had openly targeted for early repayment was well covered with over $500m of cash and readily-available liquidity and an explicit plan to use it for that repayment. The cash flow picture was strong, and the liquidity picture was stronger. By our analysis, even if there was a slowdown comparable to what retail experienced in the recession that followed the 2008 financial crisis, the company was resilient and liquid enough to follow through on its stated goals. Furthermore, the senior loans don't mature until 2025, which we believe gave the management team ample runway to continue to pursue their operating initiatives once the nearest term maturity was out of the way. Put another way, and we say this with both confidence from our hindsight analysis and humility from the actual outcome, Tailored Brands was not an exception to our credit standards.

But what we didn't anticipate back in February or even earlier was what happened next, a scenario in which the company would be forced to close substantially all of their stores for a period of time and in which people would be unable or afraid to go to retail stores. We couldn't foresee that group gatherings of any size, including proms, weddings and graduations, would be postponed or canceled. We didn't expect entire workforces to be required to work from home and for business travel (or any travel for that matter) to largely cease. And we didn't predict either a conflict with opportunistic lenders nor the stark change in the alignment of the management team with other stakeholders of the company, including the bondholders.[4]

Even so, we underwent a detailed cash flow and liquidity review of all of our issuers in March during the worst of the market declines, and this company was no exception. At the time, even taking into account the circumstances we hadn't foreseen before but could now factor in (such as the end of travel and gatherings as we know it for some period of time), we determined that Tailored Brands had sufficient liquidity to manage through at least three months without any revenue. That said, zero revenue is unrealistically conservative even for retailers in the pandemic, and in our estimation at the time, the company's runway was more likely at least 6 to 9 months even with dramatically reduced revenues. Moreover, we came to these conclusions after consulting directly with the company about the inputs and assumptions in our monthly cashflow projections. That gave us confidence that we weren't viewing this situation through rose-colored glasses; our conclusions were seemingly validated by none other than the company itself.

It is worth sharing how the mid-crisis credit analysis differs (and doesn't differ) from pre-crisis analysis. In more benign environments, our approach to fundamental analysis looks for signs of resilience. This is why we spend so much time digging into liquidity, cashflow and leverage. However, the purpose of those factors is also for exactly this type of crisis, even if the specific details of the crisis may have been

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unpredictable. Every company will bend under such circumstances, but we seek those that are unlikely to break. In other words, the priorities of our analysis don't change, but the reasons those priorities exist multiply. For example, we look to liquidity as a measure of a company's flexibility to pay down their debt. But that liquidity is also there so that if it is needed to continue operations rather than just to reduce leverage, companies can manage through difficult times until they regain stability and can use their normalized cashflow to rebuild liquidity and set themselves up for a successful refinancing anyway.

In the case of Tailored Brands, they had already benefited from their strong liquidity and cashflow position to both repay debt and reposition the company to better compete in the changing landscape of menswear; it was not an either/or proposition. Now, the timeframe they had for a recovery from the pandemic-related quarantine would be over two years, with the first debt in the capital structure (the bonds we own) not coming due for refinancing until 2022. So when the company showed a $200m unrestricted cash balance (and an additional $95m in cash restricted to inventories and capital expenditures) during a business update in early June, we felt comfortable that our modeling remained on target and that this company could weather the storm within their two year runway.

Most relevant to this discussion, the company had clearly shown the ability to make the $6m interest payment on July 1. Until they chose not to. To be clear, as we watched the COVID-19 market crisis unfold, we expected a number of retailers to run into trouble. By our models, companies such as JC Penney, Ascena Retail Group (owner of Ann Taylor and Lane Bryant) and Party City all showed dangerously low levels of cashflow and liquidity. These were companies which we saw as having a material risk of restructuring precisely because they did not have the credit cushion we saw in Tailored Brands. Two of these three companies have since filed for bankruptcy, and the third restructured out of court; we were not surprised. All of these companies were also broadly held by many credit portfolios, but our selective process excluded them.

This is all to say that, as part of our effort to understand what we could have done differently, we can verify that our credit process doesn't have a blind spot that lets through at-risk retailers indiscriminately. Rather, Tailored Brands is one of several retail credits which did make it through our rigorous process, a list which also includes Michael's Stores, Sally Beauty Supply and Caleres (owner of Famous Footwear). All of our other retail issuers have reported recent results that have shown them to be the resilient companies we expected when we invested in them before quarantine became a part of everyday life in the United States. Tailored Brands has been an exception in our portfolio even as retail difficulties have been a norm in the economy and across the corporate credit universe.

So what are we doing now? While we didn't want to find ourselves in this situation, managing through this is our job, and we have experience doing so. Both Marcus and I are experienced in extracting value from distressed credits from prior roles we have held at other firms. We have taken a leadership role among bondholders in aiming to engage the company and its advisors. At the time of writing, we are subject to a confidentiality agreement with the company as a direct result of our proactive efforts, so we are limited in what we can share. But rest assured we are working hard to ensure we (and in turn, our clients) are represented in whatever comes next for Tailored Brands. As we mentioned at the start, given where the position is valued, any value we recover offers upside from here.

Meanwhile, with respect to the risks in our portfolio, it is worth reiterating that our approach aims to avoid making bets on directional moves. As it pertains to this situation, we recognize that a selective credit portfolio actively seeking to avoid beta sensitivity comes with the potential, however unlikely, of credit events. To that end, we have always constructed a portfolio which could absorb and recover from an event even as we work hard to avoid them. Unlike many credit managers and index funds, for whom a less selective portfolio means defaults are an eventuality rather than infrequent occurrences, our strategy has never contemplated investing in issuers that have a meaningful chance of defaulting and simply trusting that we are on the right side of that outcome. We don't start our days assuming a non-zero default rate

and expecting "winners will pay for losers." We work diligently to try to avoid the losers entirely, and for eleven years, we have been successful. This focus continues with the same level of dedication our clients have come to expect from us. We are working doubly hard to position the portfolio to recover from the portfolio decline we experienced during this COVID-19 crisis and to make sure this hiccup is an exception, both now and as a general expectation from us going forward as it has been since our inception. Though we would prefer that Tailored Brands contributes to our performance going forward, our job remains the same regardless.

There are a number of ways in which managers can try to recover from a market decline, so it is important for readers to understand what we will not do. We will not style drift and shift our strategy into higher return or riskier positions to try to speed up that recovery irresponsibly. Though we are experienced in the work we are doing with Tailored Brands right now, we will not introduce a distressed credit risk profile into the portfolio. Doing so is not consistent with core fixed income. Distressed credit is not fixed income risk; rather, it is a strategy that takes equity risk using fixed income asset classes. We will not make tactical moves in the portfolio to try to capture beta in the high yield markets. Though that has been a profitable trade over the last few months in general and for some of our peers, we believe it runs counter to the underlying fundamentals of the high yield market and is fraught with risk. We will not try to ride the wave of the Federal Reserve's market backstop, whether in high yield credit, investment grade credit (where the risk of downgrades is real and widespread), or Treasury bonds (where record-low yields mean duration risk skews heavily to the downside). We believe the markets have misunderstood the Fed's intentions and are facing a potentially costly supply/demand imbalance which could turn at any moment. We will not introduce illiquid or non-transparent instruments into the portfolio. In our experience, such securities appear to offer strong risk/rewards until one factors in their embedded complexity risk, often hidden by oversimplified credit ratings which breed complacency. It would not be consistent with why we were hired for us to introduce any of these risks into our client portfolios uninvited. Rather, we will aim to deliver going forward by doing what we have always done best — picking what we believe to be good companies and holding them.

Even so, do not mistake the priority we place on consistency for inertia. We have learned much from our experience with this situation. We have used this opportunity to revisit every aspect of our credit analysis and portfolio construction processes. While we already considered the outcome of scenarios in which credits run into trouble, we must run through not just the financial outcome but also the game theory of how other market participants may behave for every credit, even in those situations where our analysis concludes that a bond is unlikely to restructure. Also, though we already consider a company's entire capital structure when we make investment decisions, we have revisited how we assess the relative risk/reward between different securities within the same debt structure. And while finding and partnering with a responsible management team is a key element of every fundamental investor's toolkit, we come to every other credit with an extra layer of skepticism even for those companies with whom we have had open dialogues and long-standing relationships.

We take full responsibility for the decision to invest in an issuer who may be on the verge of a default. That said, the dramatic turn we witnessed from a potential repayment in July to a potential default in July virtually overnight can be attributed directly to the COVID-19 global pandemic and the corporate-, policy- and health-related reactions to it. We have no other holdings that are in such circumstances, all of which have undergone the same depth of analysis both pre- and post-coronavirus that this issuer did. We strongly feel this credit event is a one-off, unique to a perfect storm of extraordinary and unforeseeable circumstances, which then set the table for opportunistic investors to force a company's hand prematurely. If these are the circumstances in which we experience our first credit event, we hope our clients will share in our humbled but affirmed confidence in our portfolio, our process and our ability to deliver on your expectations going forward.

As always, we are available for your questions, comments or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

Venkatesh Reddy
Chief Investment Officer

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