July 25, 2019

Dear Partner:

Our 2019 continued with another solid quarter. The Greenlight Capital funds (the "Partnerships") returned 5.8% for the quarter, bringing the year-to-date return to 17.4%. Each of the long portfolio, the short portfolio and macro generated a positive return in the quarter. We had five significant winners – Tesla (TSLA, short), gold, Adient (ADNT), General Motors (GM) and AerCap (AER) – which were partially offset by losses in CNX Resources (CNX) and Ensco (ESV).

In many respects, Pets.com is remembered as the poster child of the 2000 internet bubble. After all, who can forget a sock puppet and a business model of distributing pet food and supplies over the internet at negative margins? But some context is in order. Pets.com was backed and majority-owned by Amazon.com. It raised approximately $82 million in its IPO and achieved a peak market capitalization of less than $400 million. It acquired over 500,000 customers before it eventually failed. Pets.com described itself in a 10-Q from 2000 as follows:

> Pets.com, Inc. is a leading online retailer of pet products, integrating product sales with expert information on pets and their care. We are committed to serving pets and their owners with the best care possible through a broad product selection, expert information and superior service. We seek to address the entire pet products market, transcending the limited product selection of superstores, specialty stores and grocery stores. Our broad selection of approximately 15,000 SKUs is integrated with extensive pet-related information and resources designed to help consumers make informed purchasing decisions.

For those that think the 2000 bubble was the big kahuna, consider Chewy (CHWY), which went public in June 2019. CHWY described itself in its registration statement as follows:

> Our mission is to be the most trusted and convenient online destination for pet parents everywhere. Since our launch, we have created the largest pure-play pet e-tailer in the United States, offering virtually everything a pet needs. We believe that we are the preeminent online destination for pet parents as a result of our broad selection of high-quality products, which we offer at great prices and deliver with an exceptional level of care and a personal touch. We are the trusted source for pet parents and continually develop innovative ways for our customers to engage with us. We partner with more than 1,600 of the best and most trusted brands in the pet industry, and we create and offer our own outstanding private brands.

Over its life, Pets.com chewed through just over $200 million of investor capital. CHWY has burned $1.6 billion and counting. Analyst consensus is that CHWY will achieve modest operating profits in 2023. Its market value is nearly $14 billion – more than 30x Pets.com at its peak. There is a saying that over the short-term the market is a voting machine and over the long-term it is a weighing machine. We look forward to a time when there is more weighing and less voting.

2 Grand Central Tower • 140 East 45th Street, 24th Floor • New York, NY 10017
Phone: 212-973-1900 • Fax 212-973-9219 • www.greenlightcapital.com

In our early training, there was a concept that news was priced in. This meant that for high-multiple stocks, expectations of good results were already baked into the share price, and for low-multiple stocks, bad results were already discounted. The high multiple would often provide a ceiling for prized stocks – such that it took genuine incremental positive news to drive them higher. Conversely, the low multiple on out-of-favor stocks would often provide a floor such that it took genuine bad news to drive them lower.

In this market, such ceilings and floors don't seem to exist. Prized stocks continue to rise sharply based on the continuation of existing trends, without deviation, and there is no price too low for unloved stocks. The saying used to be "good things happen to cheap stocks." Our long portfolio appears to be laden with them – most trade at low- to mid-single digit P/E ratios despite improving business performance.

The most obvious example is Brighthouse Financial (BHF), which we wrote about extensively last quarter. In response to our letter, one investor asked, "What's the bear case?" At the time we replied that the story was complicated to follow. But late in the quarter, we got some clarification when two banks, Goldman Sachs and Credit Suisse, published lengthy negative reports on the same day.

These reports contain several key flaws. First, both reports value BHF's main business – variable annuities – based on the run-off value of the existing book of business. However, BHF is not in run-off; the company sells nearly $2 billion of new annuities per quarter. The bearish reports each treated the business as if it were not a going concern.

Second, both analysts significantly overestimate BHF's sensitivity to declines in interest rates. The Goldman Sachs analyst sees the potential for a nearly $1 billion hit from today's lower rates, yet this is contrary to BHF disclosures. In December (amidst a dire market backdrop), management noted that a loss of $1.2 billion would require a "correlated stress" of both a 25% decline in equity markets and a 100 basis point move lower in the 10-year Treasury.

Most importantly, neither report appropriately accounts for the lifecycle of variable annuities, particularly with respect to capital requirements. As with other life insurance products, when an insurer sells a new variable annuity, it must hold a prescribed amount of assets and capital to ensure it can meet its obligations over the life of the contract. As the annuity "seasons" and approaches its earliest payout dates, capital requirements steadily rise because the shorter timeline to payout means fewer years for the insurer to earn interest on its asset base. Eventually capital requirements peak and excess capital starts to be released back to the insurer. While a mature book of business regularly releases capital, a younger book requires an ongoing capital build.

BHF has a younger book of business than its peers. The result is that its book currently throws off less free cash flow than others. In most cases, the market pays a higher multiple for businesses that are in their investment stage and a lower multiple for businesses that are in their return of capital stage. However, the BHF bears ignore this dynamic and argue the opposite: the lower near-term cash flows should get a lower multiple. There is no justification for this view, which is the bedrock of their absurdly low price targets.

Either way, over the next few years BHF's need to build capital will peak and the headwind will turn into a tailwind. It isn't hard to envision free cash flow doubling over the next few years as the variable annuity book matures, eventually reaching $1 billion per year or more. Even now, BHF has plans to buy back $1.5 billion of stock by the end of 2021. At today's prices, that is approximately 1% of shares outstanding per month. Today, the company's market capitalization is just over $4 billion. We've digested the bear case and we continue to think that BHF is deeply undervalued at about 30% of book value and 4x earnings.

Contrast BHF with Assured Guaranty (AGO), which we remain short. AGO's insurance book is in decline and over the last few years, the company has used the run-off capital to buy back stock. AGO has bought back $500 million of stock in each of the last two years, which is similar to what BHF expects to buy back over each of the next few years. Today, the two companies have almost the same market capitalization. However, while BHF's buyback capabilities are likely to increase, AGO's are likely to decrease.

Due to its declining book of business, AGO's earnings are falling and are expected to be less than $300 million this year. In prior years, AGO obtained regulatory permission for special dividends – generally on the order of $200-300 million during the fourth quarter. This year, permission was granted approximately six months later than usual and it was for only $100 million. It appears that the regulators are limiting AGO's buyback capacity.

Perhaps it's due to AGO's smaller book and reduced earnings. Or, perhaps it's due to the company's exposure to Puerto Rico. The company has $4.5 billion of exposure to defaulted Puerto Rican debt. Its loss reserves on its entire $226 billion public finance insured portfolio are less than $700 million. On June 17, 2019 the Financial Oversight and Management Board announced a plan to restructure Puerto Rico's debt and impose large losses on bondholders. We estimate AGO's loss under this plan to be over $3 billion. While we understand the plan isn't final and will likely be improved somewhat, we don't believe the company can plausibly maintain its current GAAP loss reserves at such low levels. A large charge, which is needed now, could further impair AGO's ability to get permission for the special dividends to continue the aggressive buyback that has been supporting its stock price.

During the quarter we added a medium sized position in Chemours (CC) and small positions in Dillard's (DDS) and Scientific Games Corporation (SGMS).

CC makes titanium dioxide and fluoroproducts and was a 2015 spin-out from DuPont, which forced CC to provide indemnification for a variety of legacy environmental liabilities. We have a history with CC – it was our biggest winner in 2016-17, as the stock went from a low of $3.12 to a high of $57.23. During our first go, we debunked a bear case that the company faced $5 billion in liabilities related to a class action for those exposed to PFOA (a chemical used to make Teflon), which DuPont ceased emitting in 2004. We thought the liabilities would be much less, and ultimately, CC settled the outstanding claims for $335 million (with DuPont making an equal payment). This quarter, CC shares declined sharply in response to a new bear case that new liabilities related to firefighting foams (which contain a related chemical, PFOS) as well as continuing legacy liabilities related to PFOA will cost the company billions of dollars.

We have researched the liabilities extensively and disagree. First, neither DuPont nor CC ever made PFOS or sold firefighting foam. Second, the PFOA suits for 3,500 plaintiffs diagnosed prior to 2017 have been settled. We estimate that the liability for the 54 post-settlement suits (on behalf of plaintiffs who were diagnosed subsequently) could run into the tens of millions of dollars, not the billions claimed by the bears. We have also reviewed the environmental liabilities and observe that they have a very long tail and the contaminated sites are already under remediation.

With CC's shares having fallen from their 2017 peak of $57.23 to our average entry price of $23.18, we think a lot of bad news is priced in. The company's fluoroproducts business has high margins and favorable secular growth prospects, and we believe it is worth more than the entire current value of the company. It represents almost half of the company's earnings and should command a higher multiple.

CC is a global low-cost supplier of high-quality titanium dioxide in a highly cyclical sector. Management is attempting to reduce the cyclicality of that segment by entering into long-term pricing contracts with customers. In the meantime, it is suffering a downcycle, as earnings that peaked at $5.78 per share in 2018 are forecast to be less than $4.00 this year. However, with a year of industry destocking behind us, we expect CC's earnings to stabilize and grow in the coming years. CC has demonstrated a willingness to use free cash flow to buy back stock. That, along with a somewhat more favorable industry environment, leads us to see $10 per share in earnings power in 2021. CC shares ended the quarter at $24.00.

We re-initiated a position in DDS during the quarter. DDS is a regional department store that owns 90% of its store square footage, with low leverage and strong liquidity. In an environment in which many retailers are going out of business, DDS has delivered positive comparable store sales for the last six quarters, with 7.5% retail EBITDA margins. DDS doesn't hold quarterly earnings calls or publish periodic investor presentations like most public companies do. Instead, the company has quietly reduced its share count from 80.1 million in 2006 to an estimated 25.3 million currently, and it intends to continue repurchasing shares. Excluding shares owned by the Dillard family, employees and index funds, we estimate the effective float is 6 million shares. Given the reported short interest of 8.3 million shares, we think an interesting trading dynamic could emerge. To the extent that DDS's prospects as a retailer end up being more challenging than we expect, our entry price of $59.20 creates the real estate at $27 per owned square foot, which compares to an average of $285 per owned square foot for Nordstrom, Macy's, Kohl's, JCPenney, Simon and Seritage. DDS shares ended the quarter at $62.28.

SGMS is a gaming equipment company specializing in slot machines and instant lottery products. The company has developed thousands of games for its core business and since 2012 has monetized them via web- and mobile-based social gaming platforms. In May, SGMS publicly listed SciPlay Corporation (SCPL), its online social gaming business. Given SCPL's access to SGMS's content, its R&D expenses are generally lower than – and its margins higher than – its peers'. While consensus expects SCPL's EPS to grow at an annual rate of 23% through 2022, the shares trade at only 12x the 2020 estimate. After the IPO, SGMS continues to own 82% of SCPL, which accounted for 78% of its market capitalization at quarter-end and could be spun-off in the future. At our average entry price, SGMS's core business trades at less than 5x free cash flow. SGMS ended the quarter at $19.82.

Additionally, we have taken a new macro position against U.S. corporate credit, both investment grade and high yield. Over the last few years, corporate debt has expanded dramatically, while covenant packages and other bond-holder protections have weakened considerably. Rating agencies have been complacent and allowed debt/EBITDA and debt/equity ratios to deteriorate without a corresponding reduction in credit ratings. Meanwhile, we are a decade into an economic recovery and there are signs the economy may be slowing. Finally, credit spreads are approaching historical tights, such that the cost of betting against corporate credit is quite low. We have a fair amount of cyclical risk in our equity portfolio (which we added to by buying CC), and believe shorting corporate credit, in addition to having attractive standalone asymmetric risk-reward characteristics, provides a hedge to our long equity portfolio.

We also exited a few positions during the quarter. We exited our large position in Deutsche Pfandbriefbank with a low-teens percent compounded return over a four-year holding period. The company routinely exceeded projections and despite paying a healthy dividend, is significantly overcapitalized. We thought a substantial re-rating of the company's shares was also in order. However, management never articulated a plan to return the extra capital or otherwise improve ROE, so we became fond of these (not so) brief bank gains and moved on.

We sold BT Group with a modest gain. During our holding period management was replaced, which we thought might lead to a favorable change in corporate priorities. Unfortunately, very little has been done to prioritize shareholder interests and we moved on.

We covered our short in Mowi, a Norwegian salmon farmer, at a loss. We believed the industry would be able to overcome biological challenges to improve its overall harvest, which would cause salmon prices to decline. However, environmental complexity led to continued challenges and supply growth never came. We covered when it became clear that salmon prices would remain elevated.

Tariq Barma joined us as a research analyst in July. He caught our attention at the 2019 Sohn Investment Conference where he presented a compelling short thesis as this year's winner of The Sohn Idea Contest. Tariq joins us from Parian Global Management, a private investment partnership where he was a member of the pre-launch team. Prior to that, Tariq was an analyst at Marianas Fund Management. He began his career in 2013 as an investment banking analyst at Deutsche Bank and later joined the Consumer group at Lazard. Tariq graduated with honors from Pennsylvania State University in 2013. Welcome, Tariq!

In June, Jenn Goff married Tracy Wright and became stepmom to Kaya and Kale. For those keeping track at home, it was the second surprise wedding in Greenlight history. Congratulations, Jenn and Tracy!

At quarter-end, the largest disclosed long positions in the Partnerships were AerCap Holdings, Brighthouse Financial, CONSOL Coal Resources, General Motors and Green Brick Partners. The Partnerships had an average exposure of 120% long and 74% short.

"The most important shot in golf is the next one."

– Ben Hogan

Best Regards,

Greenlight Capital

Greenlight Capital, Inc.

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