HARDMAN & CO.

26 September 2019

# RM SECURED DIRECT LENDING

## Defensive qualities in uncertain times

**This note examines RMDL's potential performance in uncertain times. RMDL is a debt fund, and the key issues for continuing its track record of capital preservation and dividend streams are what it has done to reduce both the probability of default (POD) and the loss in the event of default (LED). We conclude that i) the initial credit assessment follows best practice, ii) accounts are closely managed on an ongoing basis, allowing early intervention, reducing both POD and LED, iii) security is structurally robust, and iv) RM has the right approach to recoveries. We believe the top four accounts would all have to default to eliminate the annual dividend.**

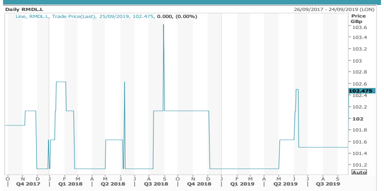
- **Limiting POD:** RMDL's effective credit assessment processes include detailed cash-driven, scenario modelling. Its close ongoing relationships allow early action on a co-operative basis with the borrower. Sponsor-backed companies, a key borrower group, operationally outperform quoted companies in a downturn.
- **Limiting LED:** In a scenario of worsening economic conditions, there will be much more focus on recoveries. We believe RMDL has the right approach to limiting LED through its culture, experience, documentation, legal structures, control of the enforcement process and risk-adjusted pricing.
- **Valuation:** RMDL trades at a small premium to NAV and to the average of its closest peers. In addition to the factors above, we estimate that further equity issues at a premium to NAV will enhance current shareholders by 1%. RMDL has not seen a major loss, and has no uncertainty discount over loan realisable values.
- **Risks:** Credit remains key for any lender, and we examine in detail the investment manager's approach. We believe the right approaches are in place to limit the probability of default and loss, in the event of default. The book shows a surprising propensity to turn over. There are modest currency and key personnel risks.
- **Investment summary:** RMDL is a non-bank lender focused on non-benchmarked, middle-market corporate debt, where competitive pressures are relatively modest, and yields can be enhanced through its service and structuring skills. Its bespoke lending is 60% self-originated (balance in small syndicates), with a current bias to non-cyclical sectors, and further counterparty diversification is achieved through having 36 loans.

### Financial summary and valuation

| Year-end Dec (£000) | 2018 | 2019E | 2020E |
|---|---|---|---|
| Profit/loss on investments | -807 | 1,130 | -450 |
| Income | 8,199 | 12,292 | 18,913 |
| Investment manager's fee | -894 | -1,276 | -1,964 |
| Other expenses | -1,134 | -1,150 | -1,350 |
| Finance costs | -1,037 | -380 | -380 |
| Pre-tax return | 4,327 | 10,616 | 14,768 |
| Dividend (p) | 6.5 | 6.9 | 6.5 |
| Dividend yield | 6.4% | 6.8% | 6.4% |
| Dividend cover (Hardman & Co basis, x) | 1.0 | 1.1 | 1.1 |
| NAV (p) | 0.97 | 1.00 | 1.01 |
| S/P premium to NAV | 5% | 2% | 1% |
| Loan book | 102,581 | 180,000 | 245,000 |

*Source: Hardman & Co Research*

### Premium Equity Closed-Ended Investment Funds



*Source: Refinitiv*

### Market data

| | |
|---|---|
| EPIC/TKR | **RMDL/RMDZ** |
| Price (p) | **101.5/106** |
| 12m High (p) | 104.0 / 106.0 |
| 12m Low (p) | 100.1 / 101.5 |
| Shares (m) | 112.20 |
| Mkt Cap (£m) | 114 |
| NAV p/shr. (p) | 98.69 |
| Free Float | 100% |
| Market | LSE Equity Inv. Instrument |

### Description

RM Secured Direct Lending (RMDL) aims to generate attractive and regular dividends through investment in debt instruments that are backed by real assets, led by exceptional management teams, and that usually demonstrate high cashflow visibility.

### Company information

| | |
|---|---|
| Chairman | Norman Crighton |
| NED | Guy Heald |
| NED | Marlene Wood |
| Inv. Mgr. | RM |
| CIO | James Robson |
| Co. Manager | Pietro Nicholls |
| AIFM | IFM |

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rmdl.co.uk

### Key shareholders

| | |
|---|---|
| CCLA | 18% |
| Quilter | 18% |
| MerianGlobal | 13% |
| Brooks MacDonald & Hawksmoor | 5% |
| CG AM & Jupiter | 4% |
| Sarasin & Charles Taylor & PAM & Seneca & Blankstone Sington | 3% |
| RM (Inv. Mgr.) | 1% |

### Diary

| | |
|---|---|
| Mid'Oct | September factsheet |

### Analyst

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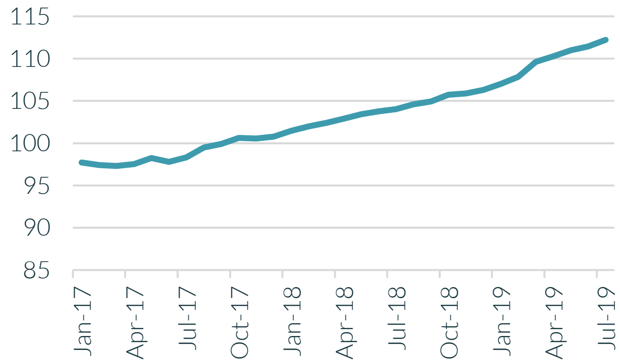
mt@hardmanandco.com

# Background

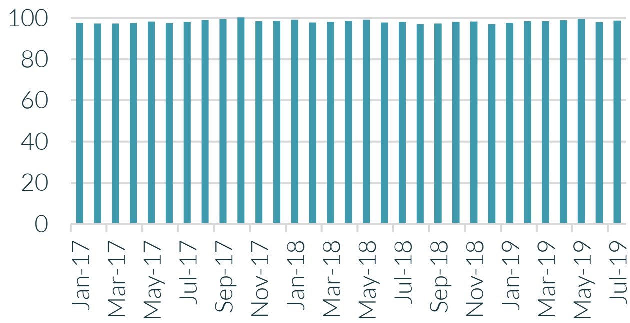
*Track record is delivering consistent and stable NAV*

When considering the outlook for RMDL's NAV and dividend, it is worth considering what it has delivered to date. The left-hand chart below shows the cumulative NAV, which has shown a remarkably stable increase month-on-month. The right-hand chart shows how stable the NAV has been, with a high to low range of 100.24p to 97.01 (i.e. just 3% volatility) since the start of 2017. It is worth noting that even this volatility is driven primarily by the timing of dividends, with a small build-up in NAV in the months ahead of the quarterly payment, and then modest falls in that month.

**Total cumulative NAV return (%, LHS)**




**NAV (p, RHS)**




*Source: RMDL factsheets, Hardman & Co Research*

*This performance is not an accident, but reflects RMDL's market, business model and risk management*

This stability has been delivered because RMDL has:

- long-term assets (current average life 3.39 years);
- been growing its yield (current average 8.62% against 8.23% at end-2017);
- predictable net interest income revenue, and is not dependent on capital gains;
- been achieving increasing economies of scale, as it has grown the portfolio;
- a niche market, where competition is relatively modest;
- a spread that reflects the complexity of deals and payment for intellectual capital used in structuring deals, not just risk;
- robust credit assessment, monitoring and collection processes (see below);
- tangible security;
- an increasingly diversified portfolio; and
- manager alignment with shareholders.

# Credit processes

## Credit assessment and ongoing monitoring

We reviewed RMDL's credit processes on pages 11-17 of our initiation note, *Predictable revenue streams generating high yield*, published on 5 June 2019. In summary, we believe RM has the right cultural approach to credit, with a focus on cashflows, stress-testing exposures through a range of scenarios, and a deep understanding of the key drivers to a customer's performance. Once on-boarded, a close relationship with the borrower is established to ensure the open and free flow of information, allowing early action to be taken in a co-operative, non-confrontational manner.

## PE performs better in downturns

*Sponsor-backed lending likely to be robust*

At the end of December 2018, 74% of RMDL's lending was sponsor-backed – i.e. Private Equity (PE). As we noted on pages 39-44 of our initiation report on Pantheon International PLC (Pantheon), *11.9% annual NAV growth since 1987*, published on 6 September 2019, the operational performance of PE companies is better in a downturn than that of the quoted markets. This view is supported by academic research, as we show with the examples below:

*Stanford academics highlighted outperformance by PE in downturn. Reasons given include long-term horizon and "dry powder" capital built ahead of downturn.*

In a piece called *Private equity firms show resilience in a downturn*, Stanford scholar Shai Bernstein noted, in September 2017, "…at the onset of the financial crisis, when the decline in investment among private equity-backed firms was much smaller. Moreover, we found that private equity-backed firms increased their assets more rapidly relative to the control group, and also enhanced their market share during the crisis." The reasons given were, "I think there were a couple of reasons that allowed private equity-backed companies to gain better access to financing resources, and, as a consequence, invest more and grow more rapidly relative to their peers. First, the longer time horizon of the private equity firms' funds (average fund life is 10 years) allowed the private equity investors to support their portfolio companies during the crisis. Moreover, the private equity firms themselves still had capital available to deploy – capital they had raised before the crisis. Consistent with this notion, we indeed found that private equity firms with more "dry powder," or non-deployed capital, at the onset of the crisis were more able to alleviate financing constraints of their portfolio companies during the crisis."

*Academics from Leeds/Nottingham universities reached similar conclusion, with PE-backed companies showing stronger performance than quoted companies*

Similarly, in a 2011 piece called *Private Equity Portfolio Company Performance Through The Recession*, academics from Leeds and Nottingham universities noted "Private equity-backed buyouts show a stronger economic performance in the period before and during the recent recession than a matched sample of private companies and listed companies. Private equity-backed buyouts show a higher return on assets, sufficient ability to cover the interest payments on their debt and higher gross margin in the recession period than before it. Growth in value added and profit is stronger than for listed companies during the recession period. Growth in turnover and employment remains positive for the PE-backed buyout sample. ….. The results imply almost 14% higher productivity and 5% higher return on assets (ROA) during the recession than matched private companies and listed companies."

PE-backed companies may have a greater degree of financial leverage, but the businesses are better-run and have better access to long-term capital – both important to delivering better revenue and EBITDA growth than quoted companies. In addition, as we also noted in our report on Pantheon, the equity element in PE deals means there is considerable "skin in the game", protecting lenders such as RMDL.

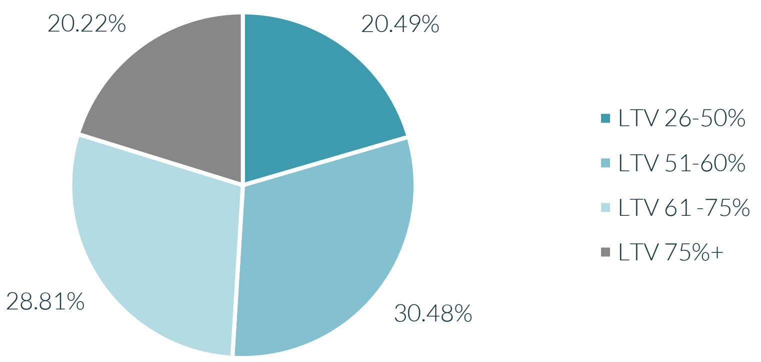
# Collections/recovery of debt

## Value of security

*ca.80% of book has LTV, which, in isolation, covers a forced sale discount*

Having taken appropriate steps to lower the probability of default, we also noted (page 17 of our initiation report on RMDL) RMDL's value of security and, particularly, the 80% of book on less than 75% loan to value (LTV), which should materially reduce any losses in the event of default. Our view is that the forced sale values will typically be ca.30% below an "open market value", and so this is an important trigger level in assessing ultimate loss.

**Proportion of portfolio by different LTV ratios (%)**




*Source: Report and accounts, Hardman & Co Research*

## Management of collections

We believe there are certain characteristics that materially influence the management of collections, and so are critically important to ultimate loss.

*Culture*

- The most important element of culture is that the individual lender sees the loan as his/hers and that he/she takes ownership of the ultimate economic return. This culture can be embedded through i) lenders being responsible for the account after drawdown, including any recovery process, ii) reward – RM, the manager, has a ca.£1m stake in RMDL, and so is directly aligned to its performance, and its staff will suffer financially should loans not be collected, iii) a continuation of position – unlike mainstream banks, where managers may be moved after four to five years, leaving their loan books behind, RM staff are likely to see much longer, unbroken service, and iv) active lender engagement in documentation – not simply leaving it to a specialist department/external legal services. We believe all these aspects are prevalent at RMDL.

*Experience*

- The management of accounts in difficulties is a specialist skill, and this is one reason why the mainstream banks have established departments dedicated specifically to this. The ability to know when restructuring a debt may be optimal, rather than enforcing security, requires experience. Similarly, what incremental covenants may be appropriate and how they are enforced again require experience. RMDL advises that its managers have had direct experience in restructuring and managing stressed or distressed loans – both at RM Funds and within previous roles.

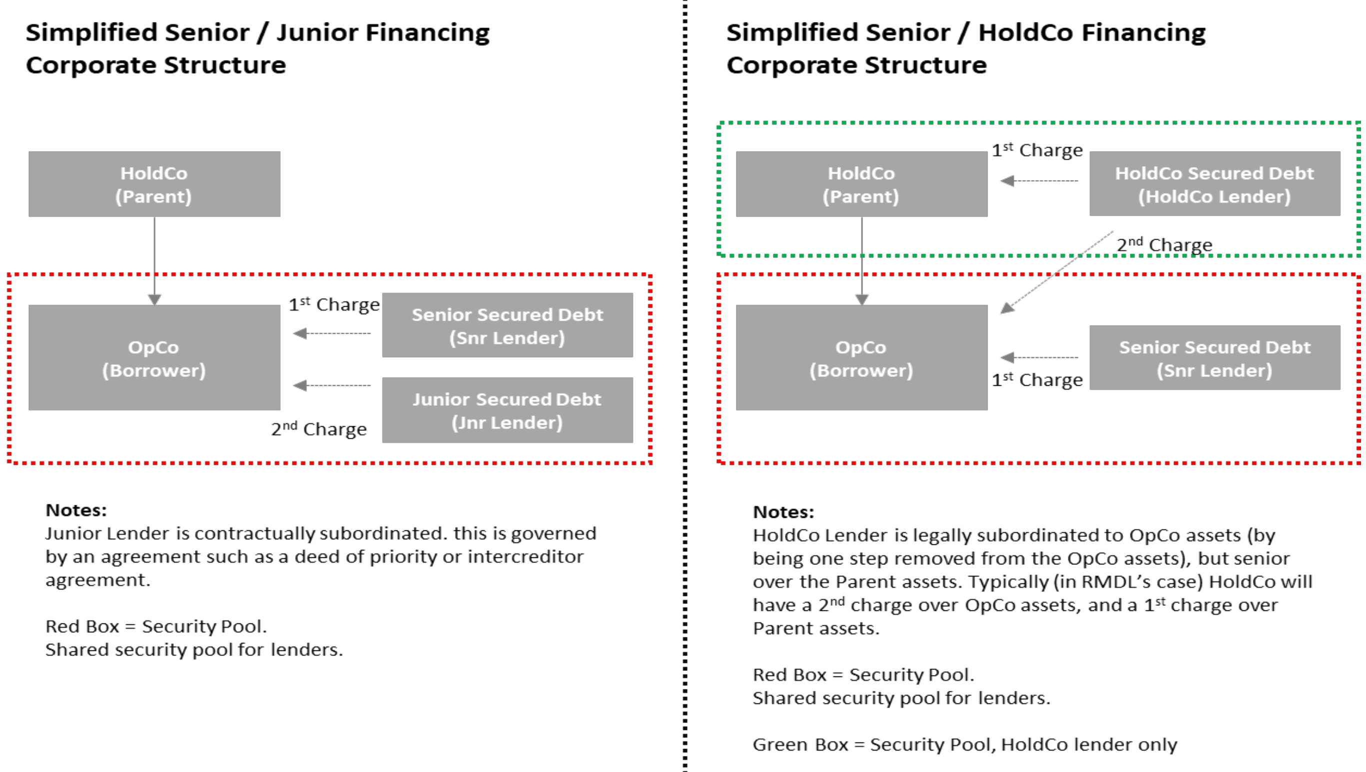
*Documentation*

- We noted, on page 18 of our initiation report, that around half the security taken in HBOS's commercial division was ineffective. We believe this is partially because the lenders did not own the process. Additionally, we note that, in the majority of RMDL's documents, the company can trigger an event of default for a borrower not filing monthly accounts on time, not renewing insurance on time, late payments, etc. The ongoing monitoring, combined with documentations structured to give RM control at an early stage, should help limit loss.

*Legal structure*

- RM also highlights that one of the benefits of a HoldCo structure (with tight covenants) is that it believes it can enforce security earlier. By having a first charge over the HoldCo assets, RM can intervene and, for example, require the sale of an operating company, before a senior debt lender to the operating company is able to enforce its security. HoldCo loans allow RM to enforce security and control the subsidiary without forcing the group into default. This can mean better value/recovery by retaining control ahead of any other lenders that could be secured over specific assets. In our view, this is predicated on having the right covenants/documentation, but the principle of early action reduces losses in the event of default being well established.

## Lending to HoldCo structures




*Source: RMDL, Hardman & Co Research*

*Limited involvement of other lenders*

- Having control of the whole enforcement process should also limit the losses. This is not only over the borrower, but also other creditors. Traditional high-yield and syndicated leverage loans have multiple investors and a longer "by committee" enforcement process, where compromises between different lenders may have to be made. For RMDL, there are some situations where there are other borrowers, but, typically, the number is very small, the focus of the other lender is the same (typically not a generalist mainstream bank), and, usually, a relationship has been established with the person doing the collection at the other lender before the process has started.

## Pricing for risk

*RM re-prices upwards loans, which are being restructured for missing covenants*

RM manages the portfolio for a risk-adjusted return. Where the risk on an account has increased through, say, a financial covenant being tripped, part of the restructuring process is the re-negotiation upwards of the rate being charged. The higher risk is compensated for on the existing book with a higher yield. This is not some theoretical principle. In our discussions with the company over the turnover rate of the portfolio, we were given a specific example – where a higher rate was charged when an early covenant had been tripped. We also note that the account involved has subsequently performed in accordance with the new agreement, providing comfort that the claimed skill in restructuring is real.

*Market-wide re-pricing may be expected*

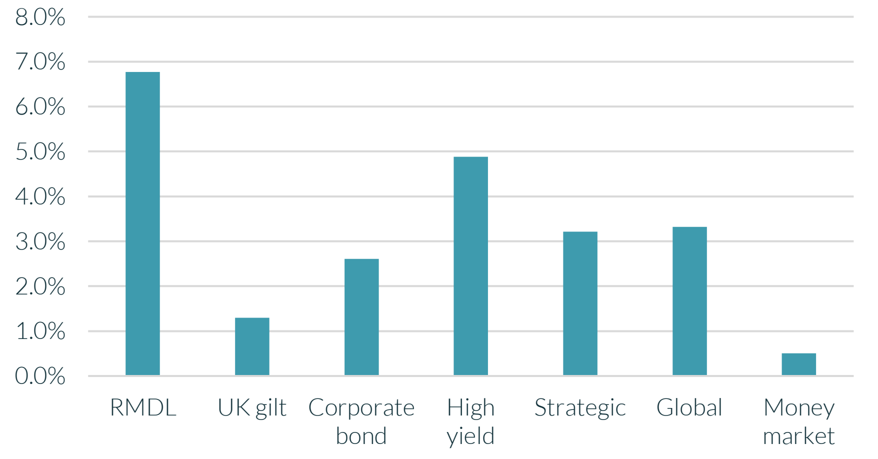
As we have outlined in other reports, should market conditions deteriorate, we would expect a more general re-pricing and for market-wide spreads to widen. We note that the most intense competition in PE has been for major deals, but RMDL's niche of more mid-sized deals has also seen some pricing compression in recent years, which may be expected to moderate. In particular, we would expect marginal players, especially non-equity financed, non-bank lenders, to withdraw from the market. This is already happening, as we note, from the comments in the Secure Trust Bank AGM statement, that "The Group has been presented with additional opportunities to successfully deploy its capital and funding in the first four months of 2019 as a result of a number of non-bank lenders citing difficulties in obtaining or renewing credit lines."

# Risk/reward

*RMDL offers investors tightly-controlled POD and LED, and offers higher yield than other asset classes*

The chart below highlights the various returns from differing types of retail income/bond funds. RMDL is currently yielding ca.5x as much as gilt funds, 2.6x corporate bond funds, 2x strategic or global funds and 1.4x the average high yield fund.

**Yield from RMDL and a range of debt funds by type (%)**




*Source: Hargreaves Lansdown funds, accessed 5 September 2019, Hardman & Co Research*

*Looking at interest received, it would take all of the top eight RMDL loans to stop payments before its yield would fall to the corporate bond rate*

This relativity can be considered in a number of ways. The table below looks at how many loans would need to stop paying interest before the income received would reduce RMDL's yield to the level of the fund types above. For example, assuming the average loan size and yield, it would need 19 out of RMDL's 36 loans to stop payments before the loss of income would reduce RMDL's yield to the level of the gilt funds. The second row in the table considers the largest loans – so, on the same basis, it would take all of the top eight RMDL loans to stop payments before its yield would fall to the corporate bond rate.

**Number of loans needing to stop all payments to reduce RMDL yield to level of different type of fund**

| | Gilt | Corporate bond | High yield | Strategic | Global | Money market |
|---|---|---|---|---|---|---|
| Average loan size | 19 | 14 | 7 | 12 | 12 | 21 |
| Largest loans | 12 | 8 | 3 | 6 | 6 | n/d |

*Source: RMDL factsheets, Hardman & Co Research*

*In terms of default, would need all of the top four exposures to default before annual dividend would be eliminated*

An alternative approach is to consider how many accounts would need to default before the dividend would be at risk. Given the quality of RMDL's security, it could be expected that the LED would be ca.20% (including all costs). Looking through the accounting point on the next page, this level of loss on the largest exposure would reduce the yield to ca.5%. It would take all the top four exposures to default before the annual dividend would be eliminated. Multiple simultaneous losses would, of course, see a monthly NAV impact, but there could still be annual dividend and annual NAV accretion.

# Credit risk: turn in cycle

*We expect market conditions to steadily deteriorate from here*

While the economic outlook is far from certain, from here, we expect a moderate decline in overall market asset quality. Such a gentle decline should be manageable, and we would expect RMDL to be involved at an early stage when a borrower faces difficulties. Some of the other considerations include non-linear risk, non-senior positions, accounting and sentiment, as detailed below.

## Non-linear risk

*While variety of factors drive yield, higher rates (up to 12%) may be perceived as higher-risk*

We note that the management of the portfolio has led to a wide distribution of expected yields. Among the top 10 holdings, the yields range from 5.1% to 12.2%. As we have identified throughout this report, such yields can be generated from a range of sources, including limited competition, service, acceptable gearing levels, structuring skills, etc. They may also be generated from taking more risk, or perhaps, very importantly, perceived as taking more risk. For investors with that view, a portfolio with a range of yields like those of RMDL would be at greater risk than one that had a range of 7%-9%, as the highest-yielding loans would be at a greater risk of default than lower-yielding ones.

## Non-senior positions

*26% of book in junior positions*

RMDL has enhanced the disclosure by splitting out HoldCo risk (July 2019: 17% of portfolio); while this risk is technically in the form of senior investments, it does carry more risk than traditional senior-secured investments. The junior subordinated debt is now 26% of the portfolio. Junior-secured debt is obviously better than being an unsecured lender, but it does not give the same control over security, and is likely to see a much higher loss in the event of default than senior-secured debt.

## Accounting

*MTM accounting may introduce some volatility*

As we noted in our section on accounting in our initiation note, RMDL adopts a mark-to- market (MTM) approach, which means that we expect more volatility in the NAV than would be seen by a business using an amortised cost approach. For example, there could be writedowns, even when the cashflows are expected to see a full recovery of principal. The higher discount rate likely in an economic downturn (reflecting wider current spreads) would see the present value of cashflows fall, even with actual cashflows unchanged. While this is a theoretical risk, we note that RMDL's credit experience would suggest that any such accounting moves in isolation could be expected to be modest.

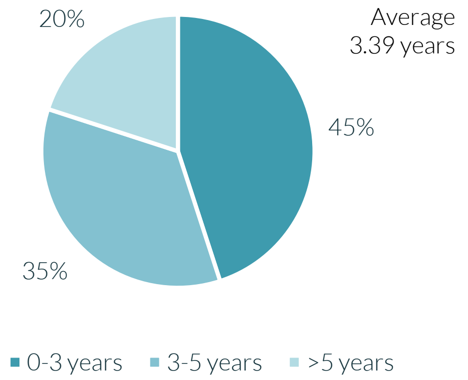
## Sentiment

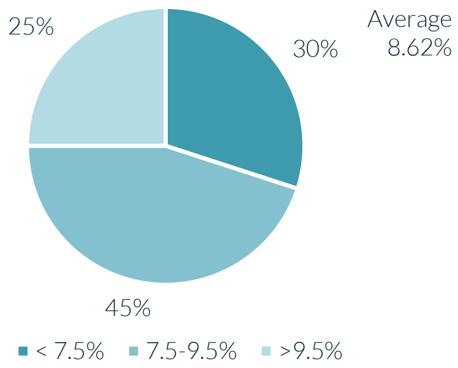
*Sentiment may be factor*

One of the hardest areas to call is the effect on sentiment. We note that Hadrian's Wall (ticker HWSL) now trades at a 20% discount to NAV, following announcements of potential problem loans, where it has taken general, rather than specific, impairments. There may be further complications, given the different accounting (amortised cost), but it is clear that there is the potential for a sustained over-reaction to newsflow until the full recovery potential is clear.

# Latest portfolio analysis

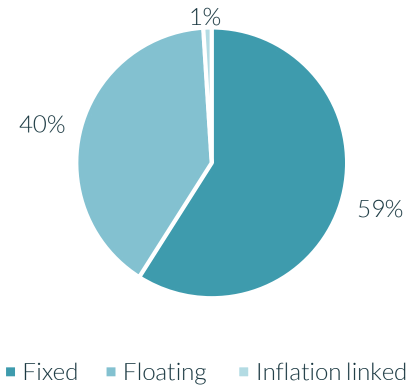
| Portfolio mix by weighted average life (%)... | ...and yield (%) |
|---|---|

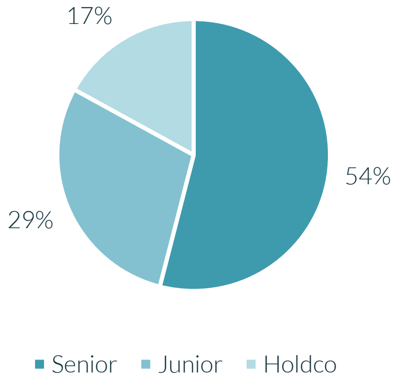



*Source: RMDL July factsheet, Hardman & Co Research*

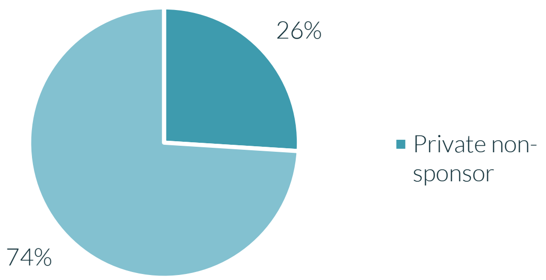
| Portfolio mix by coupon type... | ...and investment type (%) |
|---|---|

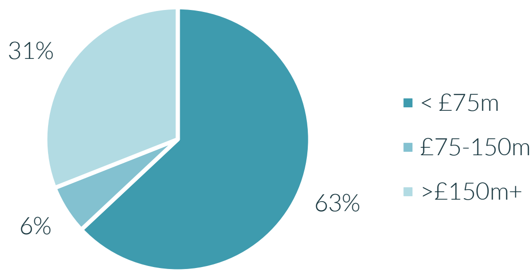



*Source: RMDL July factsheet, Hardman & Co Research*

| Portfolio mix by customer type... | ...and customer revenue (%) |
|---|---|




*Source: RMDL Portfolio Mix 2018 Report and accounts, Customer revenue Interim Report and Accounts, June 2019, Hardman & Co Research*

| Largest loans | Loan value (£m) | Expected yield (%) | Weighted average life (years) |
|---|---|---|---|
| Asset Finance | 10.19 | 8.00 | 4.42 |
| Telecommunications | 8.72 | 11.16 | 1.84 |
| Hospitality | 8.50 | 9.00 | 4.68 |
| Hospitality | 8.30 | 9.00 | 4.68 |
| Business Services | 7.00 | 6.50 | 5.32 |
| Automotive Parts Manufacturer | 6.99 | 12.00 | 3.41 |
| Forecourt Operator | 6.70 | 5.09 | 2.96 |
| Healthcare | 6.00 | 6.22 | 5.68 |
| Hospitality | 4.77 | 12.18 | 0.29 |
| Food Manufacturing | 4.50 | 9.48 | 6.02 |

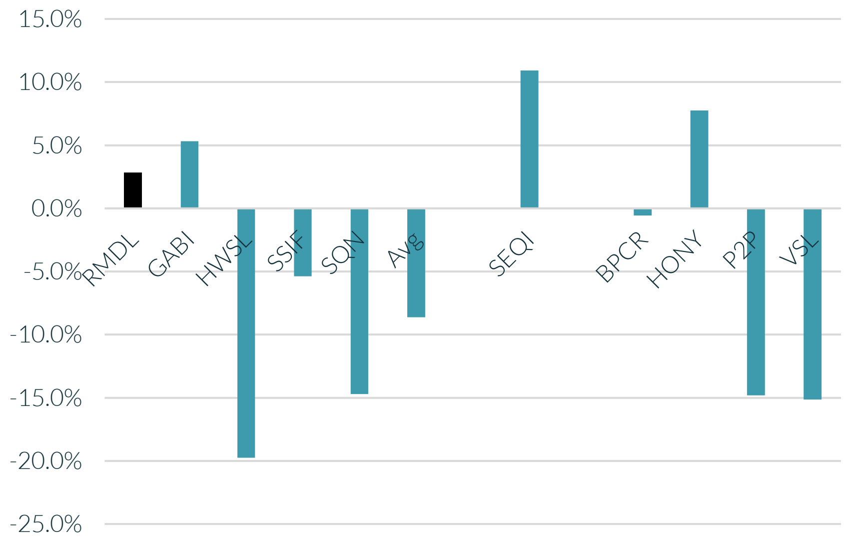
*Source: RMDL July factsheet, Hardman & Co Research*

## Valuation

*RMDL on small NAV premium to close peers*

We discussed the yield and its sustainability earlier in the report. We believe this is a key attraction for investors. In the chart below, we compare the premium/discount to NAV of RMDL with its immediate peers (tickers: GABI, HWSL, SQN). We have also included the much smaller SSIF as an asset-backed vehicle. This group, we believe, has the closest economic risk sensitivity to RMDL, and represents a tighter segregation of the companies than the recent AIC review. For the sake of completeness, we have also included those companies in the AIC sector (tickers: BPCR, HONY, P2P, VSL), excluding those in wind-down mode, but we do not believe investors should focus on them. As can be seen from the chart, the average rating for the close peers is an 8% discount to NAV. RMDL's 3% premium is thus better than average, but only modestly so, and it is not the largest premium. The wider peers – not unsurprisingly, given their broad sensitivity and history – have a much broader range of valuations.

**Premium/discount to latest NAV (%)**




*Source: Company factsheets, Hardman & Co Research, priced at 12 September 2019*

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*In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'*

*The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.*

*The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf*

*In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.*

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