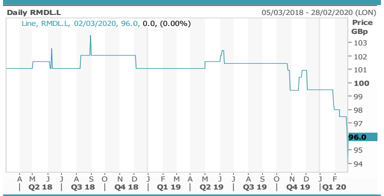
HARDMAN & CO.

Premium Equity Closed-Ended Investment Funds



Source: Refinitiv

Market data

EPIC/TKR	**RMDL/RMDZ**
Price (p)	**94.0/106.0**
12m High (p)	103.0/106.0
12m Low (p)	94.0/101.5
Shares (m)	122.24
Mkt Cap Ords (£m)	115
NAV p/shr. (p)	98.3
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	17%
Quilter	16%
MerianGlobal	13%
Brooks MacDonald & Hawksmoor	5%
CG AM & Jupiter	4%
Sarasin & Charles Taylor & PAM & Seneca & Blankstone Sington	3%
RM (Inv. Mgr.)	1%

Diary

Mid-Mar'20	February factsheet

Analyst

Mark Thomas 020 7194 7622
mt@hardmanandco.com

RM SECURED DIRECT LENDING

RMDL offers investors i) a high dividend yield (ca.7%), ii) a proven record in downside risk management, and iii) a non-correlated share price. Its monthly NAV growth has proved very stable, driven by predictable net interest income, rather than capital movements. As noted in our *initiation report*, RMDL delivers its returns via high skill and service levels, assessing, monitoring and collecting credit in line with best practice. It exploits a chosen niche, rather than taking on incremental risk. February 2020's 2% share price fall, moving the shares to a small discount to NAV, was on minimal volumes, and we believe reflects the illiquidity in the shares, rather than anything more fundamental.

- **Strategy:** RMDL operates where competition is moderate. Complex loans of £2m-£10m fall outside high-street banks' model-driven approach and are too small for market-driven competition. This, good service, structuring skills, well-developed origination and exploiting illiquidity see RMDL deliver good returns.
- **Confidence in NAV:** RMDL has 44% of its book Level 2 accounted (significant market observable inputs), supporting confidence that its NAV is real. It does not have legacy issues around historical loss situations, and the gain on its warrant sale shows an accounting conservatism. Mazars is the independent valuer.
- **Valuation:** RMDL trades at a small discount to NAV. Investors can take comfort from the NAV being provided by an external party. RMDL, to date, is one of the few consistent performers within the sector, and the focus on real assets and mid-market corporates has been a strategy that has provided consistent returns.
- **Risks:** Credit remains key for any lender, and we examine in detail the investment manager's approach. We believe the right approaches to limit both the probability of default and loss, given default, are in place. The book has shown a surprising propensity to turn over. There are modest currency and key personnel risks.
- **Investment summary:** RMDL offers investors a different asset class, with a substantial yield generated on a sustainable basis from long-term assets with predictable income streams and a strong pipeline. Any lending business needs to correctly assess and manage credit; this is done by RM Funds, which has a proven track record of doing so consistently well.

Financial summary and valuation

Year-end Dec (£000)	2018	2019E	2020E
Profit/loss on investments	-807	1,650	-325
Income	8,199	10,117	16,688
Investment manager's fee	-894	-1,038	-1,494
Other expenses	-1,134	-1,150	-1,350
Finance costs	-1,037	-380	-380
Pre-tax return	4,327	9,199	13,138
Dividend (p)	6.5	6.9	6.5
Dividend yield	6.9%	7.3%	6.9%
Dividend cover (Hardman & Co basis, x)	1.0	1.2	1.2
NAV (p)	0.97	0.99	1.01
Share price premium to NAV	-3%	-5%	-6%
Loan book	102,581	134,000	245,000

Source: Hardman & Co Research

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Executive summary

ca.7% dividend yield paid from predictable, multi-year income streams, with rising revenue yields and economies of scale

We believe two key investment attractions for RMDL are the high yield and the sustainability of the dividend. With regard to the former, the company's target annual yield of ca.6.5% appears credible (indeed is likely to be ca.7% this year) and achievable. Sustainability is supported by predictable, multi-year income streams, a rising gross return on assets, and an improving efficiency ratio. The stability of returns has led to very limited NAV volatility since launch, which we believe investors will also value. We note the additional attraction that the economic drivers supporting this yield provide diversification from other asset classes.

Niche market with limited competition, where superior returns can be earned from structuring complex deals and illiquidity premium

RMDL is operating in a part of the market where competition is moderate. High-street banks have significantly withdrawn from non-standard lending, and the size of RMDL's participation (£2m-£10m+) is too small for many corporate lenders/capital market investors looking to structure complex deals. RMDL can thus charge for intellectual capital, and its permanent capital structure means it can also exploit illiquidity premiums. The spreads it charges reflect all these factors, as well as credit.

Right policies in place to assess credit and manage it once a loan is drawn down, and also to manage accounts in difficulty. High value of security, and risk is diversified.

Credit risk management is core to any lender. We conclude that credit at RMDL is well controlled, significantly reducing the risk that impairments will put the dividend under pressure. In particular, we note i) robust credit assessment with appropriate measures specific to the bespoke nature of the clients, ii) the benefits from control post drawdown, iii) the value of security, and iv) the diversification of the portfolio. Credit risk management is about limiting the probability of default and reducing any loss in the event of default. RMDL's procedures appear well positioned to do both and, to date, there have been no major loss incidences.

Investment manager has ca.£1.2m in RMDL and aligned to shareholder interests

We note that the investment manager (RM) owns ca.1% of the company (ca.£1.2m value), as it has re-invested part of the management fees since launch. These shares are locked in for 12 months from purchase and, with a three-year programme, the manager showed great confidence that targeted returns would be achieved.

Discount management policies in place likely to limit downside

RMDL has a number of discount management policies in place to limit any downside, in particular a buyback programme should the discount hit 6% and a liquidity event at NAV (less costs) at year four. Having such policies may, of course, prevent the discount ever reaching 6%, as the market will expect the company to be a buyer at that level.

Appropriate gearing

We believe some gearing is appropriate to leverage returns. It is, in essence, taking some liquidity risk, instead of increasing credit risk, in order to achieve the same return. It must, however, be carefully managed to ensure that the company never gets into a position of being a forced seller of assets in times of distress. We believe RMDL achieves these objectives, with i) the total debt cap set at 20% of NAV, ii) the use of Zero Dividend Preference (ZDP) shares, which include no restrictive covenants, and iii) the use of a revolving facility to cover short-term needs and reduce a cash drag from issuing equity too far in advance of asset growth.

Other attractions include market presence of investment manager, income benefit from rising rates, limited number of warrant situations, and accounting significantly driven by observable inputs

Other attractions include the following: i) RM has significant scale and experience in niche markets, and has extensive and proven origination capacity; ii) with 45% of the portfolio on a floating/inflation-linked rate, RMDL has benefited and is likely to benefit from future, rising market interest rates; and iii) in a limited number of situations, RMDL has taken warrants as part of its remuneration, typically where it has wanted to share upside in growth company finance (in March 2019, this resulted in a gain over book value of £0.6m – we have not built anything further into our forecasts and regard such returns as icing on the cake, rather than core returns, but the gain on the sale of warrants does show accounting conservatism). We discuss accounting in more detail in our *initiation report,* but note that 32% of the book is on Level 2 accounting, where there are significant market inputs (peers either 100% Level 3 or value loans off IFRS9 models).

Credit is the key risk, especially as cycle is likely to turn. Gentle rise in impairments would also see improving income.

As with any lending business, investors need to focus on credit, credit, and then again credit. We believe that losses in medium-sized enterprises are likely to rise as the credit cycle turns from its current low level. This increases the risk that even good lenders may see losses, especially those with non-senior debt positions. We also note that the wide range of gross spreads RMDL generates (up to 12%) could be perceived as carrying a tail risk of a limited number of accounts, which are at well above-average credit risk. However, investors need to put any prospective turn in the credit cycle into perspective. The most likely outturn remains a gentle rise in impairments, which is highly likely to be accompanied by an increase in spreads (we have already seen some of the latter in recent months). The balance between higher fair value writedowns against increased ongoing income may even be positive.

RMDL book appears to have above-average propensity to turn over

We note from the RMDL accounts that the RMDL book has an above-average propensity to turn over (the volume of investments being redeemed relative to opening stock). However, it is important to understand the business messages behind the accounting number. Only a third of the investments are seeing principal repaid, in line with the average life of loans. We understand that half of the 2018 turnover figure relates to syndicated facilities re-pricing or re-documenting, rather than repayments of principal. In the near term, this may be considered an optical rather than real risk, as RMDL has kept the relationship and substantially the revenue streams. There is a prospective danger that such customers may seek better pricing in due course, so it is an area to watch. Noting RMDL is in a growth cycle and so already constantly seeking new investments, it will have to work even harder if more customers re-finance externally in the future. It may also face periods of increased cash drag pending re-deployment of loan repayment proceeds, although repayment penalties are usually in place to cover such losses. We believe the risk, and at this stage it is only a potential risk, thus lies in getting the right re-investments if more loans are repaid early.

Other risks, including key personnel, currency and potential conflicts of interest, appear modest

Other risks include i) key personnel risk (although we believe the long expected life of the loan book moderates the risk of losing key staff at the investment manager), ii) currency risk, as ca.20% of the book is in non-sterling loans/bonds (in addition to movements due directly to currency, the hedging policy currently segregates £1.5m of cash and, in extreme market conditions, could see further margin calls), and iii) perceived potential conflicts of interest (although we believe them to be more perception than reality).

Competitive advantages in origination

In our *initiation report,* we reviewed the business model, noting the competitive advantages in origination, the unique customer profile (including some of the specific aspects to consider when lending to private equity-backed deals, which account for 74% of book), and RM's approach to recoveries and arrears management. We also detailed the portfolio mix at that time and compared it with peers. In addition, we considered the fee structure, for both the investment manager's fees and what the investors pay, together with the economies of scale noted above.

Fair value accounting may, in extreme downside scenario, see more volatility, as NAV will be market-sentiment-driven. In normal conditions, likely to be perceived as truer picture of realisable asset values at each accounting date.

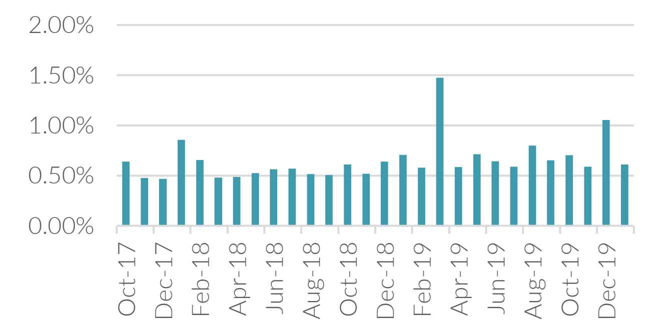
In the section on accounting in that note, we detailed the implications for RMDL in valuing its loan book off fair value accounting. In normal market conditions, we do not believe this will make a material difference to peers, who value loans at amortised cost but, in adverse conditions, this may see a lower value at RMDL, as it will include a market-sentiment discount. There may also be more volatility. Such an approach, though, especially with 32% of assets based off observable market prices, is likely to be viewed by investors as more reflective of the actual realisable value of the assets at each valuation point. In the financial section, we provided a Hardman & Co adjusted profit and loss to give investors a view on what the profit and loss may look like on an amortised cost basis. For the purposes of the Forum, we believe investors should focus more on the portfolio characteristics detailed on the next page.

In terms of valuation, we believe the significant and sustainable yield will be a key investor consideration. RMDL trades at a small discount to NAV and premium to the average of its closest peers.

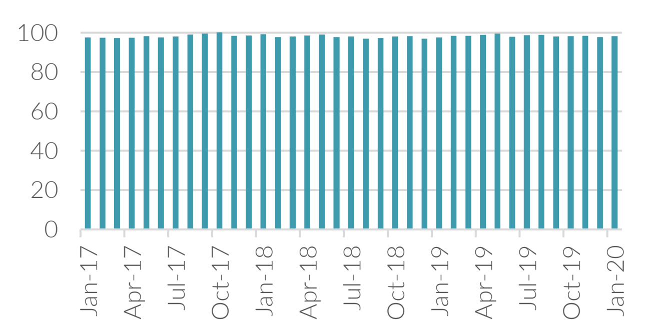
Portfolio

The key messages we take from the portfolio stats below are i) incredibly stable NAV generated from net interest income (the spike reflects early repayment penalties), ii) stable average life, iii) rising yields, and iv) more junior and Hold co structures (see initiation report for more detail on these vehicles and how risk is managed in them).

Monthly NII as % of NAV (%)...

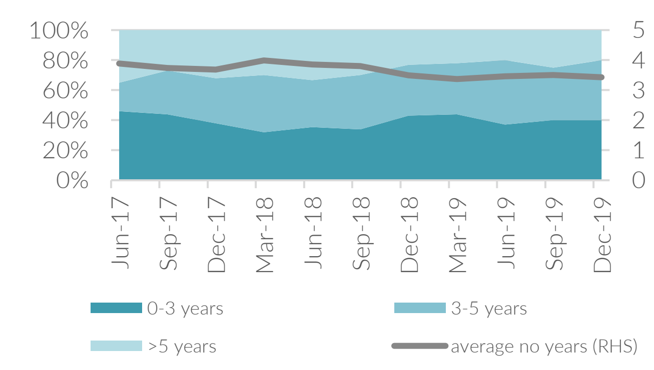


... NAV has been remarkably stable (p)

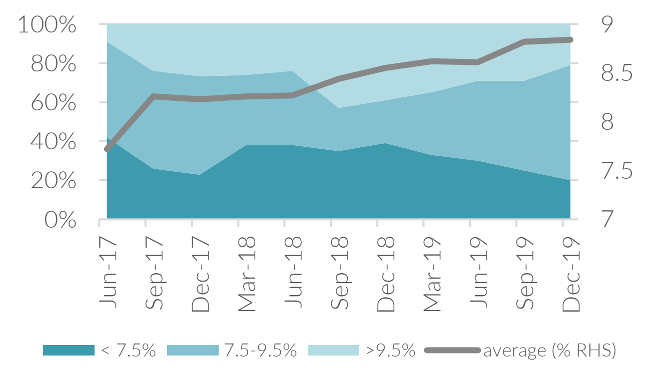


Source: RMDL factsheets, Hardman & Co Research

Portfolio mix by weighted average life (%)...

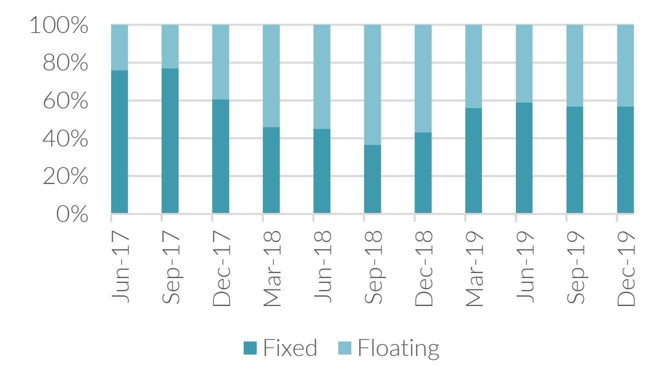


...and yield (%)

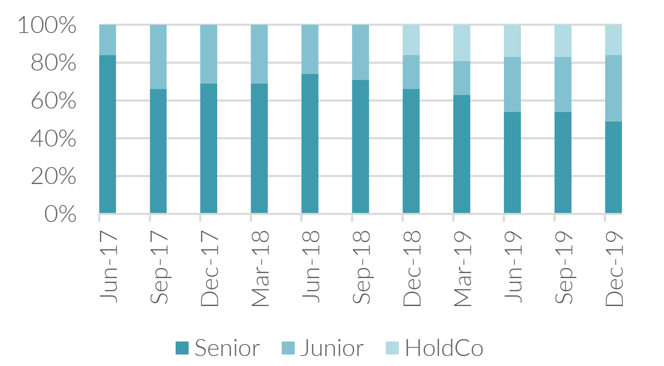


Source: RMDL factsheets, Hardman & Co Research

Portfolio mix by coupon type (%)...



...and investment type (%)



Source: RMDL factsheets, Hardman & Co Research

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