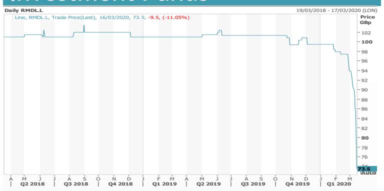
17 March 2020

Premium Equity Closed-Ended Investment Funds



Source: Refinitiv

Market data

EPIC/TKR	**RMDL/RMDZ**
Price (p)	**77.0/10.0**
12m High (p)	103.0/106.0
12m Low (p)	77.0/101.5
Shares (m)	122.24
Mkt Cap Ords (£m)	94.1
NAV p/shr. (p)	98.74
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-Apr'20	March factsheet

Analyst

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RM SECURED DIRECT LENDING

At the *Hardman & Co Investor Forum presentation*, RMDL summarised the investment opportunity as "RM Secured Direct Lending offers access to a diverse portfolio of secured loans with good collateral – overall the portfolio is high income due to the ability of the manager to capture the complexity premium". It offers investors i) a high dividend yield (ca.9%), ii) a proven record in downside risk management, and iii) a non-correlated share price. Its monthly NAV has been very stable, driven by predictable net interest income. We examined these themes and how RMDL assesses, monitors and collects credit in our *initiation report*.

- **Presentation:** The presentation focused on i) RM Fund manager overview, ii) overview of current conditions, iii) direct lending opportunity, iv) how RMDL exploits this opportunity, v) strong corporate governance, and vi) the resultant portfolio. It re-confirmed our confidence in the risk controls and appetite.

- **Q&A:** The questions in our forum were i) credit – sector exposure to hotels (23% book) and loss experience, ii) the shareholder structure of the trust, iii) why would a borrower come to RMDL, iv) why buy credit fund now, v) the impact of current conditions on mark-to-market value, and vi) confidence in NAV. Answers later.

- **Valuation:** With recent market-wide turmoil, RMDL now trades at a 22% discount to the end-February NAV. Until recently, it was on a premium. RMDL, to date, is one of the few consistent performers within the sector as the business has proved much more resilient than the share price making this discount anomalous.

- **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 assess and manage credit correctly; this is carried out 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	7.0	6.5
Dividend yield	8.4%	9.1%	8.4%
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	-21%	-22%	-23%
Loan book	102,581	134,000	245,000

Source: Hardman & Co Research

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Hardman executive summary

ca.9% 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.9.1% 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 record discount to NAV when historically it has been at a premium.

Manager's Forum presentation

Summary

RM Secured Direct Lending PLC (the "Company") is a £120m market capitalisation investment trust, which aims to preserve capital and generate a dividend of 6.5p per annum, paid quarterly. RM Funds (the "Investment Manager") aims to achieve this through a real asset lending strategy, by providing loans to borrowers across a variety of sectors. Since inception, it has delivered dividends of 17.72p (2016 4.2p, 2017 6.5p, 2018 7.025p). The NAV has been stable (opening NAV December 2016: 98p closing NAV 31 January 2020: 98.31). There is a strong manager alignment, with the investment manager owning 1.1m shares and committed to make further purchases.

Manager overview

RM Funds specialises in alternative asset fund management with ca.$300m assets under management. It was founded in 2010 and currently manages RM Secured Direct Lending PLC ("RMDL") and VT RM Alternative Income ("RMAI"). The 36-month track record for RMDL, is stable NAV and stable income. The 20-month track record for RMAI, is that it is ranked 2/130 Citywire Conservative GBP for total return, 1/130 for max drawdown. The leadership team include: i) Petro Nicholls with 14 years of experience and expertise in corporate lending and credit structuring including advising listed and unlisted and government related entities on credit; and ii) James Robson with 22 years of experience and expertise in risk management and traded credit and the former Head of European Corporate Credit Trading at HSBC.

Hardman view: The core to us is the culture of the manager. Anyone can lend money but getting it back requires the right experience and approach to credit assessment, monitoring and control. Our discussions with RM give us confidence in that core requirement.

Current market conditions

The three key themes are: i) credit spreads are at historically tight levels despite considerable macro risk – there is room for significant spread widening and disorderly market conditions to reduce high yield and leverage loan prices; ii) default rates are at historically low levels reflecting the tail end of business cycle – defaults are likely to pick up from here; and iii) covenants at historically weak and borrower-friendly levels – losses in default likely to be higher than previous cycles (although we note the probability of default is likely to be less).

Hardman view: We concur with the managers, and we believe the consensus view, that market-wide credit will deteriorate from here. When the tide goes out, you learn who has been swimming naked and RM's record to date has been excellent. The worsening market impairment position should improve pricing and so revenue opportunities.

RM Secured Direct Lending opportunity

The key points the manager made here were: i) access to an illiquid asset class; ii) proven ability of manager to source opportunities; iii) offering enhanced security over traditional high-yield and leverage loan investments; iv) robust investor protections through covenants, secured assets and high collateralisation levels; v) RMDL offers fixed income fund exposure with a modest duration; vi) in the chosen niche there is limited competition, but deep opportunity set; and viii) RMDL can capture illiquidity & complexity premium.

Hardman view: We explored these issues in our initiation note. We especially highlight the credit management, and limited competition in a chosen niche where skill can generate enhanced returns. As noted above, the majority of the book is sponsor-backed (i.e. private equity), which can be a demanding and challenging client. We also direct investors to the section on economic sensitivity on pages 42-46 in our note on the PE fund of fund investor Pantheon International. While some investors focus on the gearing, PE-backed companies outperform the market in downturns, partially because they have more committed funding lines, improving operational efficiency and a long-term focused investor.

Approach to lending

RM's approach to lending is as follows: i) all due diligence is in-house; ii) loans benefit from robust security packages designed to maximise protection; iii) interest rate protection is built in; iv) there is in-depth knowledge of borrowers and their business; v) credit committee retains oversight and involvement throughout the life the investment / loan; and vi) there is active post-investment monitoring.

Hardman view: We believe RMDL is a lender to its fingertips. It is not a technology or marketing company that happens to be in lending. While some credit difficulties and impairment are possible/to be expected in any book, the culture of RMDL from credit assessment, monitoring and collections is likely to limit both the probability of default and the loss in the event of default.

Governance

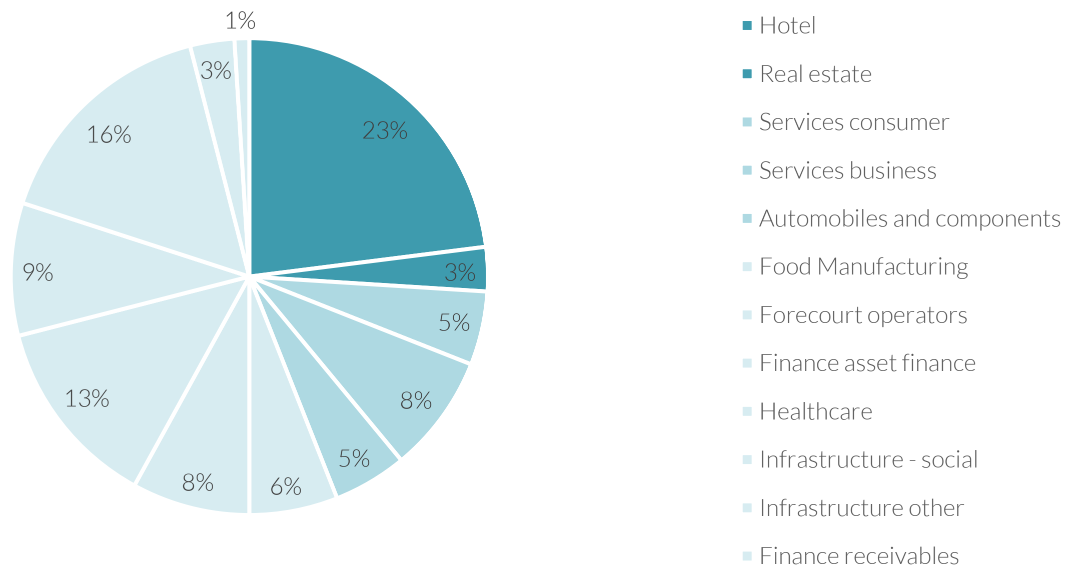
The four pillars of strong governance were identified as: i) a strong RMDL Board consisting of Norman Crighton (Chairman), Guy Heald (Non-Executive Director), and Marlene Wood (Non-executive Director and Chair of the Audit Committee); ii) independent valuation agent in Mazars LLP; iii) appropriate accounting policies - marking to fair value; and iv) excellent investor disclosures/monthly reporting.

Hardman view: The focus on strong corporate governance has never been higher. Again, we emphasise the importance of culture and in particular, will the board challenge the manager in a positive, constructive way to protect shareholder value. We believe RMDL has such a board.

Portfolio defensively positioned

We detail the portfolio in the section below. It is, however, worth highlighting the sector diversity shown in the manager's presentation. We have shaded the sectors according to our view as to how investors will perceive them. Three quarters, we believe are defensive. Even in the highest risk sectors (hotel and real estate), we note management's comment about security, strong covenants allowing early intervention and its use of stress testing in advance of lending. Losses also cannot be ruled out in low-risk areas – for example, fuel purchase from forecourts will fall if there is mass isolation, but the impact of a short but sharp interruption to business life may be offset by the government interventions announced in the budget.

Sector allocations (%) at end-December 2019



Note: Hardman & Co shading between perceived higher risk sectors (darkest blue), medium risk (medium blue) and low risk (light blue)
Source: RMDL, Hardman & Co Research

Q&A

During the course of the Forum, there was the opportunity for investors to ask questions in both a formal and an informal setting. We believe the key areas of focus were:

Credit quality – what can management say about the hotel exposures and what has been bad debt experience more generally? RMDL highlighted the borrower equity in the deals (low LTV) and that, unlike many lenders, covenants are not compromised. Accordingly, there is the option for an early intervention, which should reduce the losses in the event of a default with, for example, customer cashflows locked up in the lending structure and not available for other creditors/uses. Management sees the business, which earns yields in excess of 9%, as a good risk/return opportunity. Management also highlighted that, with mark-to-market accounting, there is visibility on the monthly changes in the books' creditworthiness and there had not been any "down the drain" situations.

Hardman view: *Credit is absolutely fundamental to a lender and we gave investors a detailed review of RMDL's processes and approach in our* initiation note *and 26 September 2019 note* Defensive qualities in uncertain times *and our 6 January 2020 note* Social infrastructure: RMDL an alternative alternative. *Losses can never be ruled out in any lender, but we believe RMDL has the right culture to limit the probability of them happening and the scale of loss when they do happen.*

Shareholder structure of the trust – are there any dominant players? RMDL highlighted the broad institutional holdings (see front page) with over 50 names on the books. It also highlighted the efforts to give best-in-class disclosure.

Why would a borrower come to RMDL? RMDL highlighted that, for many customers, the service they get from their bank for anything other than mainstream lending can be poor. Borrowers can get shoe-horned into inappropriate boxes. Providing quality service, in complex situations with borrower-led solutions makes RMDL very attractive.

Why buy credit fund now? We note the resilience in the portfolio and that the NAV stability reflects this. There is a price for everything and the discount of ca.10% appears anomalous with RNDL's historical record.

What is the impact of current conditions on mark-to-market value? RMDL notes that the market index spread had widened from ca.200bp to ca.500bps with the risk aversion recently seen. RMDL had not tightened its spreads as spreads rallied and likewise will be less affected in business terms from widening now. The index in three days tightened by 55bp to 445 and has proved extremely volatile.

Hardman view: *It is impossible to read across from the market indices to RMDL's own book given the company-specific nature of the security and covenants in complex situations. Investors also need to bear in mind the relatively short life of the book and there is also a partial offset from lower benchmark rates.*

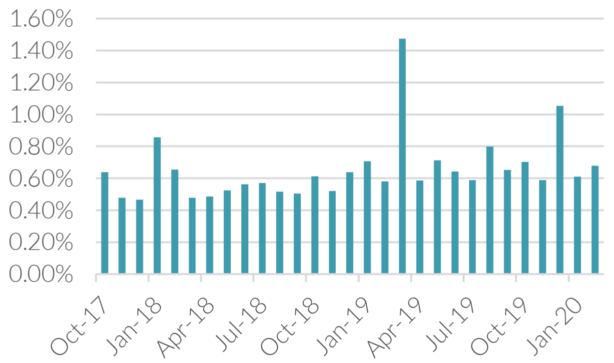
How do we get confidence in NAV/what are the external valuation checks and balances? More than 30% of the book is from external prices and there is an independent valuer (Mazars).

Hardman view: *Being able to verify the NAV is hugely important and again we went into some detail in our initiation report. It needs external pairs of eyes, a robust and experienced board and, perhaps most importantly, the right culture. RMDL appears to have the right checks and balances in place.*

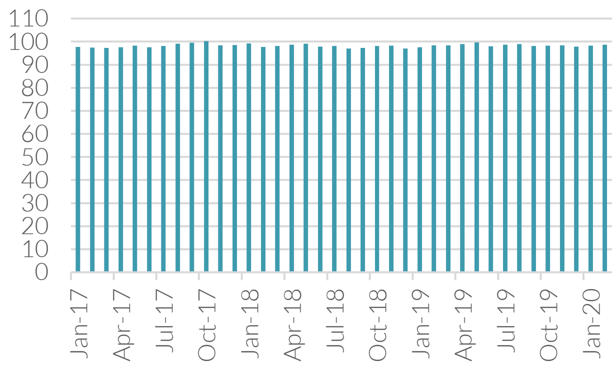
Portfolio

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 (%)...

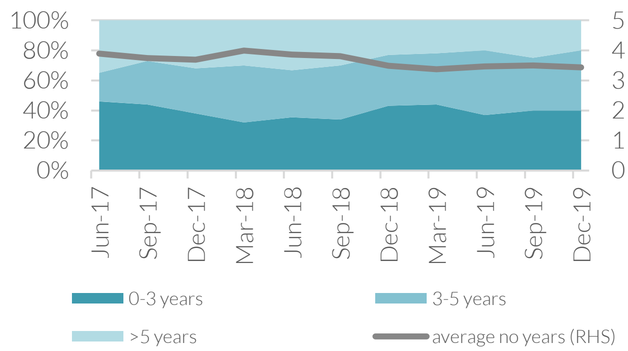


... NAV has been remarkably stable (p)

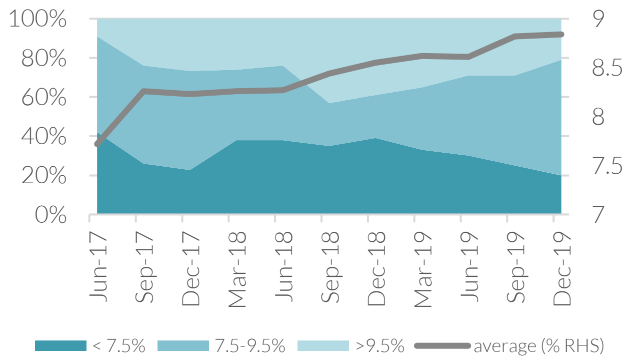


Source: RMDL factsheets, Hardman & Co Research

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

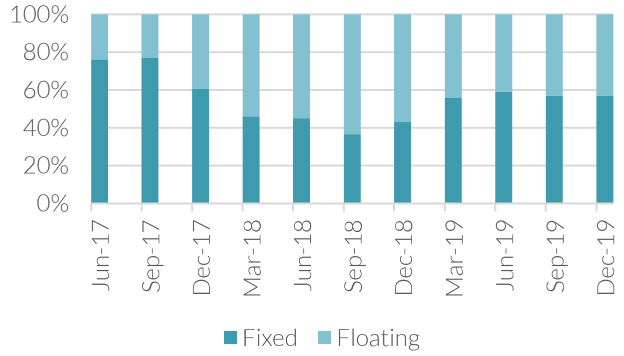


...and yield (%)

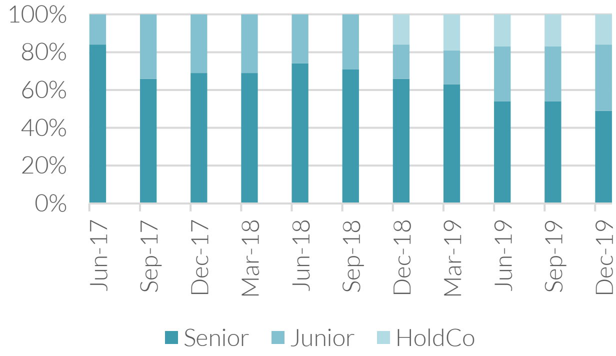


Source: RMDL factsheets, Hardman & Co Research

Portfolio mix by coupon type (%)...



...and investment type (%)



Source: RMDL factsheets, Hardman & Co Research

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Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

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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