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SQN Secured Income Fund

Update
29 January 2019

Summary

SQN Secured Income Fund (SSIF) lends to small and medium-sized businesses, targeting a 7p dividend paid monthly and a total return of 8% net of costs.

The company, previously named the SME Loan Fund, has been transformed under the new manager Dawn Kendall of SQN Asset Management, who took over in April 2017. A number of funds in the peer to peer lending space have run into trouble in recent months and the new strategy of SSIF is designed to avoid these errors and benefit from the reduction of competition in this niche area.

The new strategy focuses on direct lending to corporates, originated and underwritten by the manager, with exposure to P2P platforms cut to 33% from 100%, thanks to jettisoning investments with poorer underwriting standards made by the previous manager. Platform-sourced investments will fall to just 20% of the portfolio when the manager-led transformation has been completed, allowing the manager greater control over the quality of the underlying loans.

The company is designed to take advantage of a gap in the market: banks do little lending in the £1m to £20m issue size space due to regulatory capital requirements and the complexity of the deals, meaning that SSIF can be highly selective and generate yields of 9-12% on their lending. Under the new manager the dividend, forecast by the manager to be 7p this financial year (for a prospective yield of 7.6%), we understand will be covered once committed capital is deployed by the end of February.

Thanks to a (since reversed) dividend cut when the manager changed and an overhang of stock held by an investor associated with the previous management, Somerston, the company has slipped onto a discount of 4%. Somerston has now agreed to sell the majority of its 28% shareholding either in the market or to the new manager, which will reduce the overhang and diversify the shareholder base. We understand a capital raise is planned for the first quarter of 2019, in order to take advantage of the opportunities the managers see in this overlooked area. The company will conduct a continuation vote if the net assets are less than £250m on 31 December 2019.

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Portfolio

SQN Secured Income lends to small and mid-sized enterprises (SMEs), targeting a total return of 8% per annum with a dividend of 7%. The company is designed to take advantage of a gap in the market: banks do much less lending in the £1m to £20m loan size bracket due to stringent regulatory capital requirements and the complexity of the deals, meaning that SSIF can select the most creditworthy enterprises and generate significant yields on their lending. Peer-to-peer lending, on the other hand, is typically of a much smaller scale, with loans less than £1m made through platforms. Lending decisions are based more on algorithmic models with less individual due diligence (the pools of loans are just too large for that).

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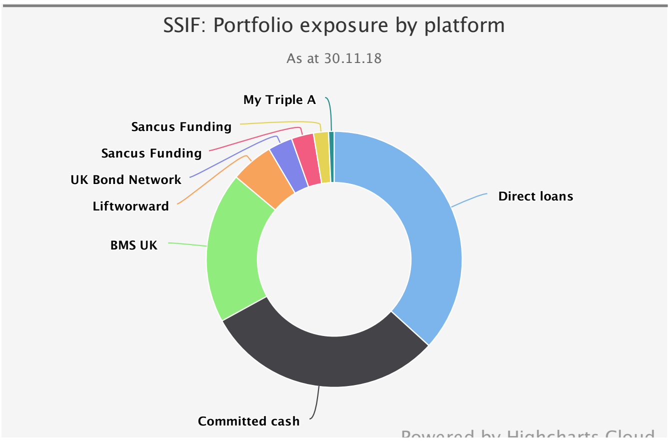
The target yield range for the underlying direct loans is 9-12%, which provides a cushion to the return targets once fees and default losses are taken into account.

In moving away from the peer-to-peer lending platform investments to more selective direct lending of a larger loan size, the company aims to leverage SQN's extensive credit experience and resources to generate more secure yields than the platform lending companies. According to data from JPM Cazenove, the five listed platform lending investment companies are on an average discount of 9.1%, despite the most successful one, Honeycomb, trading on a 13% premium. During 2018, NAVs (ex dividends) fell in value, and they are all below 100p, as they struggle to live up to their forecast yields without taking on poor quality or bad loans.

As part of the revised strategy under the new manager, SSIF only buys senior loans which are secured against real assets or cash flows, with each individual borrower assessed on an individual and qualitative basis rather than by an algorithm or automated credit scoring model. The company has been managed by Dawn Kendall since April 2017, during which time she has overhauled the investment process. Lending through P2P platforms has been cut from 100% down to 33%, with a target of below 20% exposure to be achieved this year. Direct loans now make up 67% of the portfolio, which is likely to rise to 80% and remain at that level in the future. The size disparity and the indiscriminate nature of platform lending is hinted at by the concentration of the two parts of the portfolio. The £18.9m invested directly is made up of 10 loans, while the £17.5m invested through platforms is made up of 78 loans. There is £17m in cash in the portfolio, as of 30 November, of which £11.7m has been committed and a further £5m subject to final review of the terms. In total, £15m is expected to be drawn down by the end of February, at which time the company will be effectively fully invested.

Fig.1: Portfolio Exposure By Platform



Source: SQN Asset Management

Since SQN's appointment, the worst-performing platform investments have been sold, which explains the build-up of cash. The portfolio retains a major holding in BMS UK, which makes up just under 20% of the portfolio. The intention is not to add to this as further capital is raised, shrinking it as a proportion of the portfolio. There are five smaller platform investments. Dawn says that she has been able to generate better returns from this part of the portfolio too by being more engaged with the individual loans. SQN employ three lawyers well versed in credit recovery, and SQN has been much more involved with the platforms, requiring monthly reports on impairments and challenging them where possible. The team have been able to negotiate better recovery rates from underlying individual investments which had been declared as impaired by the platforms.

The peer-to-peer platform lenders have not seen their strategies tested during a recession, and the short track record of this strategy means that it hasn't either. Dawn aims to "recession-proof" the portfolio by focusing on downside risk in credit selection. Loans are very carefully selected after extensive individual due diligence. First, Dawn looks for non-cyclical businesses which are themselves relatively "recession-proof". This means where debt serviceability is high and scenario analysis demonstrates a balance sheet that is resilient to tough times. She avoids businesses which are over-exposed to the consumer or to one customer or sector, particularly when they are troubled. Loans are not made to individuals, but Dawn also avoids lending to companies backed by the credit of single individuals, both of which have caused problems for the wider peer-to-peer sector.

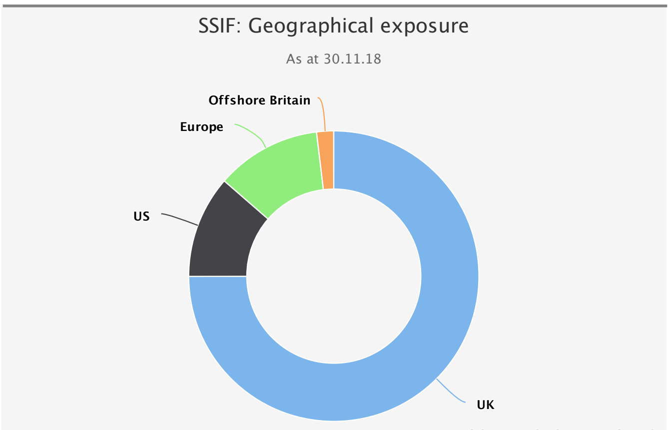
Secondly, when borrowers do get into trouble, the team works closely with them to ameliorate the situation. It is important to recognise that in this part of the market, with very small businesses, often with inexperienced and under-resourced management, the investment team can add real value to a business having analysed its accounts with a level of expertise otherwise beyond the borrower.

The portfolio also limits interest rate risk. Although all loans are fixed rate, the average maturity of the portfolio (excluding cash) is just 2.5 years, with the longest loan term 7.3 years. This is much reduced from the average maturity of eight years when Dawn took over the company, reducing interest rate risk and the amount of time shareholders are exposed to the individual borrower. Three years is Dawn's preferred maturity, with the intention being to extend at that point for a further two years and continue the relationship with the borrower. The longest duration loans are through the BMS UK platform. The current duration of the portfolio 2.5 years.

The company targets loans of £1m to £20m, although until it grows for practical reasons it is currently restricted to a maximum of around £5m. One of the benefits of raising more capital will be to allow the company to take advantage of larger scale opportunities. There is a limit of 10% lent to a single issuer although this will be 5% ideally, and as the company grows should shrink to that size. Direct lending is a labour-intensive business, there are no brokers or research to rely on, and intensive on-the-ground work is necessary.

The company will not invest more than 20% in a single sector, although otherwise industry allocation is a derivative of stock selection, and is expected to reflect the anti-cyclical and anti-consumer bias. Geographically, the company will invest between 60% and 80% in the UK. As of the end of November, there was 11% invested in the US and 14% in Europe.

Fig.2: Geographical Exposure



Source: SQN Asset Management

Committed cash for investments includes US exposure to a project of turning empty shopping centres – empty due to the migration of retailing online – into virtual reality playgrounds. SSIF provides bridge financing backed by the property owner of the first mall of £5m, with many other projects in the pipeline should this be successful. The company will be able to partake in more of them should it successfully raise funds.

European exposure is to the German property market. SSIF has provided bridge financing to companies taking advantage of the tax rebates the German government offers for property renovations. Property investors can receive a tax rebate worth 100% of the costs of refurbishing an aging property if they own it for at least ten years. SSIF has lent at 12% to a company buying properties with the aim of renovating them and selling the property to key workers with the tax rebate. The short-term loan is backed by the mortgage on the property. Again, it will be able to do larger deals should the planned fund raising be successful. The debt is secured against the property.

One other interesting area for the fund is film financing. The company supplies two to three-year loans secured against the pre-sales and tax credits at the final stage of film development. This can earn the company yields of 12% to 18% with attractive risk profiles. The debt is secured against a completion bond and cashflows are supported by at least two times the value of sales to a global audience including airlines.

All ex-Sterling exposure is hedged back. Given the current interest rate differential, the US dollar exposure is a slight net cost to the fund, but Dawn has reduced this exposure in recent months to avoid the drag on NAV – we note that at least one of the company's peers has suffered from over-exposure to US loans during a period of high interest rate differentials and therefore hedging costs.

Dawn estimates the pipeline of agreed and prospective investments to be roughly £66m. Of this £15m will be invested by the end of February and the remainder will require a capital raise for the company to be able to buy. Current potential new investments include a secured loan to refinance and emergency vehicle service company, books of performing loans being sold by mainstream European banks., and a working capital loan to an oil industry service company.

Gearing

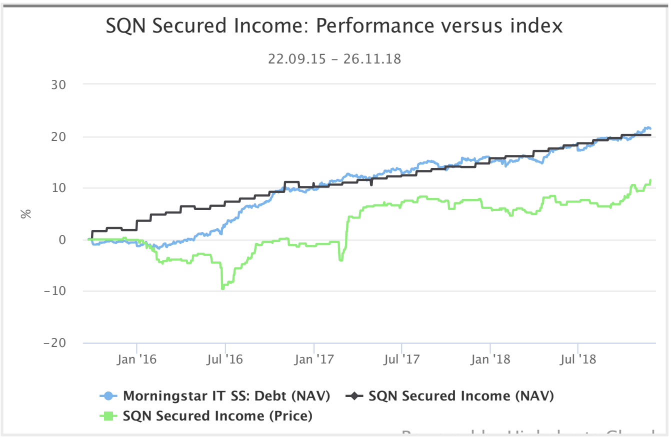
The company does not currently have a gearing facility, but it is an option being discussed by the board and management company, and the manager may look to employ up to 35% of gearing in the future once the planned capital raises are effected. The prospectus allows borrowings of up to 150% of NAV on a look-through basis, i.e. including the gearing of the platforms in which it invested.

Returns

The company's NAV total return has been 21% (or 6% pa) since launch in September 2015 thanks to the income delivered. The NAV stands at 96p, meaning there has been a small erosion of capital from the initial IPO, once costs had been paid and foreign exchange hedging has been taken into account.

Under the previous manager, the company was not paying a covered dividend. This means that after NAV initially rose ex dividends, it later began to erode, falling around 5% from its peak as a proportion of the dividend had to be paid from capital. As we discuss in the dividend section, the dividend was rebased from 8p to 6.25p in April 2017 before being brought back up to 7p in August 2018, which will be fully covered at the end of February. This resetting of the dividend policy to a level that ensures it can be covered should begin to reverse this erosion, and in the longer run the renewed dividend policy provides a cushion between the offered 7p dividend and 9-12% income on the loans.

Fig.3: Performance Since Launch



Source: Morningstar

Dividend

The company pays dividends monthly, and targets 7p a share for the coming years. The company has paid five monthly dividends of 0.583p in the current 2019 financial year, consistent with a 7p full year dividend and a 7.6% yield on the current share price. Under the previous manager the company had an over-ambitious 8p dividend target, which it was failing to match, and dividends were therefore uncovered. Faced with a shortfall for 2017, Dawn rebased expectations to 6.25p for 2017 and 7p for 2018. Both targets have been exceeded. The 7p per share dividend will be fully covered after costs of 2% once the cash from platform sales is fully deployed in agreed commitments as the prospective yield on the underlying portfolio is 9.4%.

Management

Dawn Kendall joined SQN Capital Management in August 2017 to take over management of the trust. Dawn was previously a partner and portfolio manager at fixed income specialist TwentyFour Asset Management. Her career includes spells as a senior bond strategist at Investec Wealth & Investment, head of fixed income at Architas, deputy head of fixed income at Newton Investment Management and working for SG Warburg (now UBS) investment bank.

SQN run a total of £1.63bn in collateralized, income-producing investments. This includes seven private funds in the US and the UK-listed, £484m SQN Asset Finance Income investment trust. In the UK, SQN has an origination team of three people and a credit analyst team of five people. Both teams have been hitherto focused on the equipment leasing business, but they are a source of investment ideas for investments for SSIF through their contacts in industry and the markets. Dawn also draws on her contacts built up over a thirty-year career, who have been particularly useful in expanding the European assets in the fund.

Ideas go through an initial "triage" process, during which a first analysis of the creditworthiness of the borrower is done, as well as an analysis of the legalities and the risks, the size of the deal and how the idea would fit within the portfolio. Those which pass this hurdle then go into a full analysis. At this stage, the level of investigation is intense. The accounts of the business are examined, but so are those of clients and suppliers. The personal wealth and situation of borrowers and close family is also investigated, Companies House checked and all avenues followed to understand the risks of lending to these businesses. This level of analysis of individual loans is not done by the platforms, which is one reason why the managers believe the losses on this company should be considerably lower and the dividend more secure. Ideas which pass this second stage are then invested in when sizing and liquidity parameters are met.

Discount

The company's shares trade on a discount of 4%. Aside from a general wariness towards the sector, one reason for this is the perceived overhang of stock owned by the previous owner of the company, Somerston. This will be substantially cleared following Somerston's decision to sell 80% of its 28% stake in the company into the market at a 2.2% discount to the end October NAV. SQN has agreed to buy any shares not taken up at the same price (95p).

Although the board has the ability to conduct buybacks, it has not so far utilised them, with the ambition being to grow the size of the company, not shrink it. We understand that the board has the ambition for an equity issue in the first quarter of 2019. This should provide the manager with the ammunition to take advantage of the numerous attractive opportunities highlighted above in the portfolio section. The company has previously committed to conduct a continuation vote if its net assets are less than £250m on 31 December 2019. SQN has undertaken not to vote any shares it purchases from Somerston at this ballot should it go ahead.

Charges

The OCF is 2.12% on a historic basis, but this doesn't reflect the changes to the fee arrangements following the termination of the sub-adviser arrangement with the previous manager. Post that rearrangement and at the current size, the OCF drops to 2%. As such, the capital raise programme will reduce costs for all shareholders. For example, if roughly £75m is raised and therefore the fund grows to £125m, we understand that the OCF would fall to 1.45%.

The management fee is 1% per annum on net assets. The manager is also paid a structuring fee of 1% on the loans it originates itself, except where they are bought from the manager or the manager's other funds. This is included in the spread between the lending rate and dividend yield and could be compared to the trading costs in a fund trading listed securities.

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