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SQN Secured Income Fund

Update
21 January 2020

SSIF's shares are yielding 8%, and it is one of few trusts to pay a monthly dividend...

Summary

SQN Secured Income Fund (SSIF) lends to small businesses, paying a fully covered 7p annual dividend in monthly instalments. SSIF has been transformed under manager Dawn Kendall, of SQN Asset Management, who took over in August 2017. A portfolio of senior secured direct loans has been built up and legacy investments in troubled peer-to-peer platforms sold down. Dividend cover has been achieved under the new asset mix, which generates an underlying portfolio yield of 10%, more than enough potential to meet the target of a net 8% total return per annum.

The company is designed to take advantage of a gap in the market created by banks' low levels of lending in the £1m-to-£20m loan size bracket due to regulatory capital requirements and the complexity of the deals. SQN tells us that this means SSIF can be highly selective and generate yields of 9%–12% on its loans.

Thanks to a historic dividend cut when the manager changed (since reversed), as well as an overhang of stock held by an investor associated with the previous management, the company has slipped onto a discount (currently 7.7%). The company therefore decided to conduct a continuation vote if net assets were less than £250m on 31 December 2019. With net assets of c. £50m at the time of writing, the company is exploring options for its future.

We understand that the managers have tabled two options for shareholders at this point. One option is that investors could choose to allow the manager to continue with the current strategy, selling down the remainder of the legacy portfolio and completing the transformation into a direct lending proposition. This could include taking advantage of the 35% gearing allowed, which could boost the dividend to up to 9.5p and, were the discount to then close, the trust could seek to scale up with further share issuance. Alternatively, if shareholders wanted the company to wind up and return cash to shareholders, the managers have estimated this would take two to three years to execute.

A related party to the previous manager, Somerston, retains 28% of the shares and so any decision will likely require Somerston's agreement. We understand SQN is in discussion with Somerston and other shareholders to gauge their opinions on the best route forward.

Analyst's View

Dawn has done a good job in completely overhauling the portfolio since taking over, and the current direct lending investments appear to offer an exceptional yield and the potential to be uncorrelated to major equity and bond indices. The challenge now is to get the trust up to scale, which first requires a positive continuation vote. The outcome remains uncertain, however, with the views of Somerston likely to be crucial.

Key Information:

As at	16/01/20
Price (p)	85
Discount (%)	-7.7
OCF (%)	2.03
Turnover Ratio	0.0
Yield (%)	8.2
Gearing (%)	-5
Ticker	SSIF
Shares (£)	52,660,350
Market cap (£)	44,761,298

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We think it would be a shame were investors to choose to wind up, as the level of yield the company could potentially provide is quite considerable compared to mainstream sectors. Moreover, it pays a monthly dividend, rare amongst investment companies and prized by investors living off their income. We also note that the direct lending sector has seen a number of trusts run into trouble, while SSIF's experience, thanks to the work done by Dawn on restructuring the fund, is in marked contrast. The covered dividend is one piece of evidence, as is the fact the trust has suffered no losses yet on the loans made under SQN's tenure, although this remains a relatively risky area to invest. In our view, the discount of 7.7% reflects the large shareholding owned by Somerston and the sector as a whole being out of favour.

Analyst's View

BULL	BEAR
A highly attractive yield with a fully covered dividend	Stock overhang needs to be cleared for the discount to narrow
A broad opportunity set which lends itself to scaling up	UK exposure brings with it 'Brexit risk'
Strategy is uncorrelated to other markets such as equity, bonds and real estate	Lending to smaller businesses brings higher risks to default

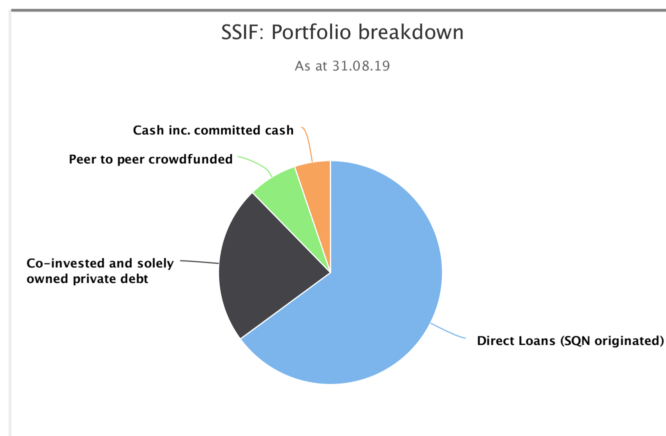
Portfolio

SQN Secured Income Fund (SSIF) lends to small and mid-sized enterprises (SMEs), targeting a total return of 8% per annum with a dividend of 7%. The company is a turnaround story, with the portfolio having been completely transformed under Dawn Kendall, who took over management on behalf of SQN in 2017. Previously, the trust had focused on peer-to-peer lending platforms, but it is now a very different proposition with a new strategy centred on direct lending to SMEs which we understand are starved of funding in the current lending environment.

The direct loans made since Dawn took over are earning a high average coupon of 10.9%, reflecting the risks of lending to small businesses and the structural lack of other options for borrowers in the space. The first two loans have matured with no impairments and the cash has been swiftly re-invested, showing there is potential in the model and the funding pipeline. The 13 remaining loans now make up 66% of the portfolio, with co-invested and solely owned legacy debt totalling 22% with a further 7% in peer-to-peer platforms; there is 5.4% cash.

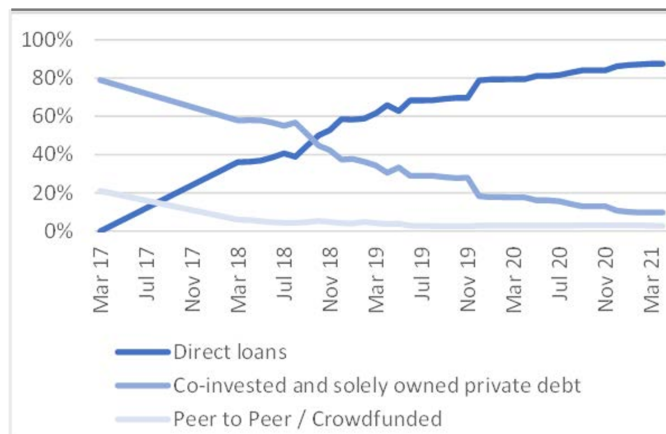
With the trust targeting an annual distribution of 7p per share, the 10.9% being earnt on the direct loans implies a significant cushion to the payout, although lower yields on the legacy debt and on the drag from cash held after legacy investments mature has meant that full cover has only recently been achieved (at the end of August 2019). With the inherited debt now almost entirely in run-off, the direct loans can now become the engine of future performance. Based on the current maturity profiles of legacy debt investments, the projected glide path of exposures will see legacy investments fall to under 10% by July 2020.

Fig.1: Portfolio Structure



Source: SQN Asset Management

Fig.2: Projected Portfolio Structure



Source: SQN Asset Management

SSIF's direct lending strategy is designed to take advantage of a gap in the market created by banks doing much less lending in the £1m-to-£20m loan size bracket than they used to 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 its 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.

In moving away from the platform investments to more selective direct lending of a larger loan size, SSIF has been able to leverage SQN's extensive credit experience

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and resources to generate more secure yields than the platform lending companies and a more stable NAV, with impairments so far coming exclusively from the legacy debt. Stability and security come from SSIF only buying 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.

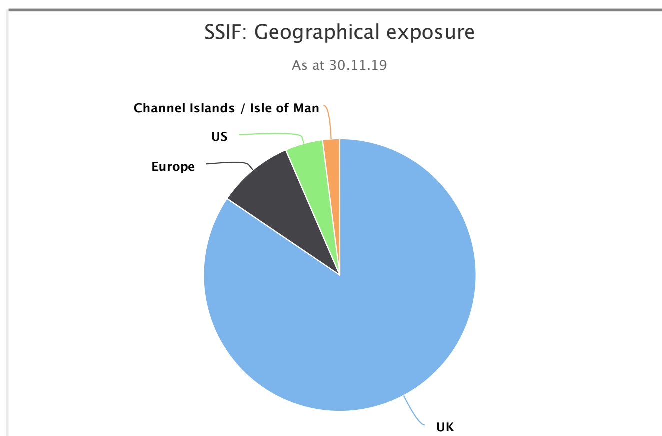
Dawn aims to 'recession-proof' the portfolio by focusing on downside risk in credit selection and looking for non-cyclical businesses which are themselves relatively 'recession-proof' (i.e. where debt serviceability is high and scenario analysis demonstrates a balance sheet that is resilient to tough 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, and Dawn also avoids lending to companies backed by the credit of single individuals, both of which have caused problems for the peer-to-peer sector.

SQN's expertise in direct lending means that when legacy debtors have got in trouble, Dawn and the team at SQN can work closely with them to ameliorate the situation and ensure the maximum amount is clawed back. When it comes to the direct loans, it is important to recognise that the very small businesses the trust lends to can have inexperienced and under-resourced management. This means that the investment team have a lot to offer to a business, both in how to better manage its business to avoid problems, and in coping with problems if they do arise.

The portfolio also limits interest-rate risk. Although all loans are fixed rate, the average maturity of the portfolio (excluding cash) is just 2.9 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 for initial direct loans, with the intention being to extend at that point for a further two years and continue the relationship with the borrower. The duration is expected to fall significantly as we progress through 2020, as the largest legacy co-investment is wound down (this is the largest contributor to duration).

The company has a limit of 20% in any single sector, although otherwise industry allocation is a derivative of "stock selection" and is expected to reflect the anti-cyclical and anti-consumer bias. The largest sector exposure is to the marketing, advertising and media industry at 24.3%. The second largest is to the marine industry at 9.6%, and the third to healthcare at 1.6%. Geographically, the company concentrates on the UK, although it has the ability to lend abroad (in Europe and the US). Hedging costs have hitherto encouraged Dawn to stay within the sterling zone for the most part, although we note the interest-rate differential between the US and UK looks likely to close, given the likely resolution on Brexit following December's election result. This might make investments in dollars more attractive and opens the door for the trust to leverage SQN's much larger business in the US. As of the end of November, there was 8.9% invested in Europe and 4.4% in the USA. Excluding legacy positions, this falls to 7.3% and 0%.

Fig.3: Geographic Allocation



Source: SQN Asset Management

The diversity of the borrowers reduces thematic or sector risk, as is evident from the list of selected borrowers below. We understand from Dawn that the loans are all performing as expected, with no impairments, although it should be noted that it is still early, and this is a risky market segment to invest in. Nevertheless, this is testament to the detailed due diligence work done on the underlying companies prior to investment and in drafting the terms of the loans, which is where SQN's resources are a big advantage.

Selected Direct Loan Positions

BUSINESS	RATE
Medical services company with an NHS contract	10%
AIM-listed specialist laser and LED manufacturer	10%
Wholesale lending business with UK-wide client base	10%
Pre-sales and tax rebate finance	10-12%
Marine services company based in Aberdeen	10%
Diversified loan portfolio serviced by a Vienna-listed, UK-based finance company	10%

Source: SQN Asset Management

Working in this segment of the loan market requires extensive analysis, given there is no broker or research coverage to rely on. Financial analysis focuses on cash generation, with companies tested for a 10% fall in cash generation, with little impact expected if SSIF is to invest.

Covenants are designed to give SSIF control of assets and bank accounts in extremis, as well as including standard provisions which, for example, allow full repayment if a company changes control.

In the remaining legacy portfolio, the largest allocation (14.7%) is to a UK platform which is in run-off. SSIF has taken control of the underlying portfolio of loans thanks to the platform breaching the terms of the loan note. This allows Dawn and the team at SQN to ensure that the maximum value is extracted from the book as it is run down, and means that cash should be made available earlier than it would otherwise and be re-invested into direct loans. In both the remaining co-investments and the platform investments, we understand Dawn has been able to use the resources of SQN to extract the maximum possible value, exercising covenants and taking legal action where appropriate.

Gearing

SSIF does not currently have a gearing facility; however, it has the ability to borrow up to 35% of NAV (at the time of drawdown). Using this ability in full is currently being considered as a way for the trust to boost dividends. In the annual report, the manager estimates this could boost the dividend to the 9–10% range. According to our calculations, if the new funds were invested at the weighted average rate of the SQN-originated loans of 11%, and we assume a cost of debt of 4% or lower, then this level would be achievable.

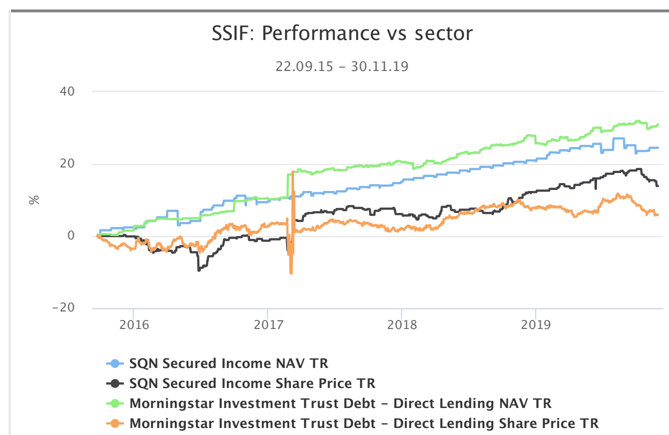
Performance

SSIF has delivered an NAV total return of 22.4% since it was launched in 2015, or 5.3% per annum on average. Over the same period, the NAV per share has fallen to 93.2p, with positive returns due to the income generated. Along with small effects from launch costs and hedging costs, the NAV fall reflects the impairments to the investments made by the previous manager, most notably those made through platforms.

Under the previous manager the company was not paying a covered dividend, meaning that after the NAV initially rose (excluding dividends), it later began to erode, falling around 5% from its peak because 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, at which level it is now fully covered. This resetting of the dividend should hopefully begin to reverse this erosion, and in the longer run the new dividend policy provides a cushion between the offered 7p dividend and the 10.6% weighted average income on the loans being currently achieved. Additionally, this should allow for limited NAV gains with an expectation of an 8% total return.

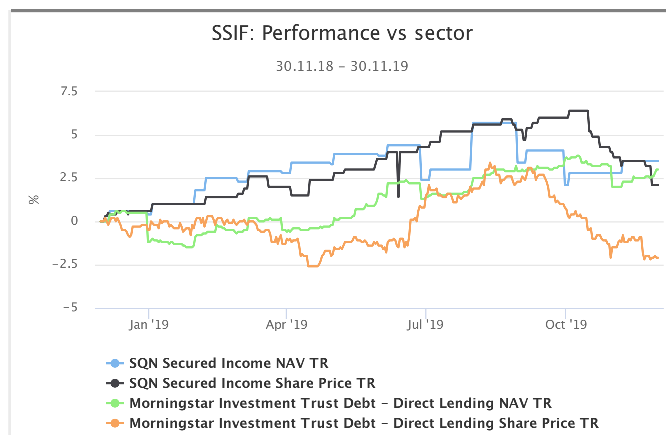
That said, in recent months there have continued to be impairments on investments made by the previous manager, with the current manager warning of the possibility of more to come. In the 2019 financial year, the company raised the impairment provisions it takes under IFRS 9 to reflect expected losses to default by 2.22%, with all of this attributable to the platform loans. After the accounts were published a further 2p a share of impairments has been taken, relating to two of the three remaining loan platforms and some other credit-loss allowances. Dawn also tells us there remains the risk of further write-downs in the US peer-to-peer lender. Meanwhile, the UK peer-to-peer lender is in run-off, so Dawn and the team are monitoring the situation carefully to ensure the maximum value for shareholders is obtained through the process. The final, Spanish, peer-to-peer lender is also in run-off, but Dawn believes that all these losses have been taken, and some of the write-downs may even be recovered during the run-off process. Notwithstanding these issues, given the health of the rest of the portfolio the board remains confident that the 8%

Fig.4: Performance Since Launch



Source: Morningstar

Fig.5: One-Year Performance



Source: Morningstar

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total return target can be met in the 2020 financial year. Over the past year the NAV total return has been 3.5%, behind the 3% average of the AIC Debt – Direct Lending sector.

Dividend

SSIF is one of very few investment trusts to offer a monthly income to investors. Last year it paid a 7p dividend made up of equal instalments, and on the current share price that represents a yield of 8.2%. According to a regulatory news statement in August 2019, the dividend was fully covered by income on the portfolio, representing quite a turnaround given the state of the portfolio which Dawn inherited in 2017. The company had originally been aiming for an 8p dividend but had had to cut the payout, given there was little hope of paying that amount from income.

With impairments on the underlying platform loans, the outlook appeared bleak. Dawn therefore rebased the dividend to 6.25p in 2017 and to 7p in 2018, both of which were met, before full cover of the 7p dividend was achieved in recent months. Although it has not given guidance on the dividend for this financial year, the board has stated it believes an 8% total return for the 2020 financial year is achievable. Given full dividend cover has now been achieved on a running basis, we believe the 7p dividend could be maintained assuming no defaults, with the first payments of the 2020 year consistent with that (at 0.58p a month). Should the board opt to use the gearing it is permitted to use – 35% of NAV at the time of drawing down – the manager estimates that the dividend could be boosted to 9.5p a share (according to the annual report). We calculate that if the new funds were invested at the weighted average rate of the SQN-originated loans of 11%, and we assume a cost of debt of 4% or lower, then this level would be achievable and it is one of the options being considered for the future of the company.

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, as head of fixed income at Architas, as deputy head of fixed income at Newton Investment Management and working for investment bank SG Warburg (now UBS).

SQN manages private and public funds for institutional and retail investors with AUM of $1.1bn in direct discretionary portfolios and a further $1.6bn in advisory mandates for a number of small to mid-sized US insurance companies.

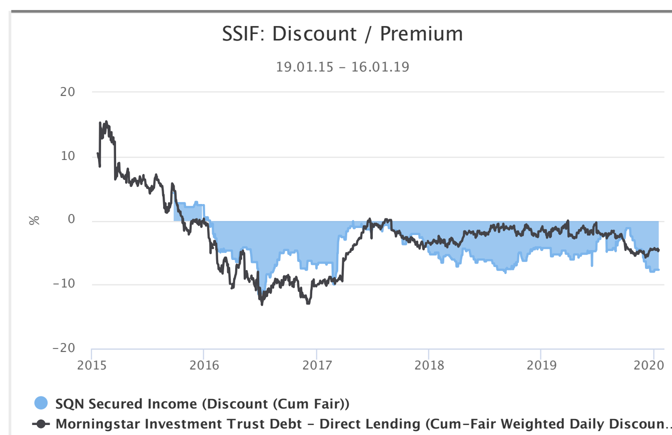
A significant part of the UK AUM includes the LSE-listed SQN Asset Finance Income investment trust. In the UK, SQN has an origination team of three people and a credit analyst team of five people. Both teams have hitherto been focused on the equipment-leasing business, but they are now a source of investment ideas for SSIF through their contacts in industry and the markets. Dawn also draws on the contacts she has built up over a thirty-year career.

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, and 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 are also investigated, Companies House is checked and all avenues are 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 if sizing and liquidity parameters are met.

Discount

The company's shares trade on a discount of 7.7% to the most recent (30 November 2019) NAV, and the weighted average discount on the AIC's Direct Lending sector is 4.7%. However, there is a high variance between individual trusts, with four on double-digit discounts and two trading on a premium. We believe that the current discount likely reflects the perceived overhang of stock owned by the largest shareholder, Somerston, which owns 28% of the share capital. Somerston has expressed willingness to exit its position, albeit at a narrower discount to NAV than the current figure. However, in our view the discount

Fig.6: Discount



Source: Morningstar

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is still relatively narrow because Dawn has managed to successfully repair the income account and meet the 7p-a-year dividend target fully covered.

Although the board has the ability to conduct buybacks, it has not so far utilised this power, with the ambition being to grow the size of the company, not shrink it. The company committed to conduct a continuation vote if its net assets were less than £250m on 31 December 2019, which is now certain to be held given SSIF's current c£50m size. As such, the company is exploring options for its future. We understand that the managers have tabled two options for shareholders at this point. One option is that investors could choose to allow the manager to continue with the current strategy, selling down the remainder of the legacy portfolio and completing the transformation into a direct lending proposition. This could include taking advantage of the 35% gearing allowed, which could boost the dividend to up to 9.5p and, were the discount to then close, the trust could seek to scale up with further share issuance. Alternatively, if shareholders wanted the company to wind up and return cash to shareholders, the managers have estimated this would take two to three years to execute.

Charges

SSIF's OCF is 2%, which compares to an average of 1.79% for the AIC Debt – Direct Lending sector. The OCF includes a management fee of 1% of NAV, and there is no performance fee. The manager is 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. The structuring fee is paid out of the interest due on the loan and could be compared to the trading costs in a fund trading listed securities. The latest KID RIY is 2.23%.

ESG

The company does not have an ESG policy, although we understand that the manager is finalising a policy which is due to be published shortly. SQN is also in the process of reviewing the requirements needed to become a UNPRI signatory. However, the manager tells us that she does consider ESG factors when making investments, and that responsible and sustainable lending is key to the success of the strategy. That said, given there is currently no written policy, the trust may not appeal to those committed to investing on ESG grounds.

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