HARDMAN & CO.

6 January 2020

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RM SECURED DIRECT LENDING

Social infrastructure: RMDL an alternative alternative

Inter alia, we reviewed social infrastructure investment companies in our note "*Secure income" REITs – Safe harbour available*, published on 22 March 2019. In this note, we consider how RMDL may be viewed as an alternative to these investments with social infrastructure becoming an increasingly important part of its portfolio. We conclude that RMDL: i) offers a higher dividend yield; ii) carries less downside risk; and iii) has a non-correlated share price. RMDL does not have the same equity-upside, but offers investors a different portfolio option. As noted in our *initiation*, RMDL delivers its returns through high skill and service levels.

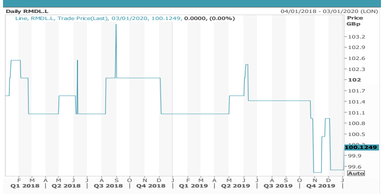
- **Limiting POD:** We believe that investors are primarily in social infrastructure investments for what they see as a secure income, rather than for capital gains. For such investors, ones seeking safety and downside protection, having an element invested in higher-yielding, lower-downside-risk RMDL may be appropriate.
- **Other news:** In December, one of RMDL's larger investments pre-paid early. The associated fees have added 0.51p (0.5%) to the NAV. While announcing this deal, RMDL also advised that the majority of the recent £10m equity raise proceeds has been deployed. The pipeline appears to be very strong.
- **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 marks loans to market.
- **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 by service and structuring skills. Its bespoke lending is 59% self-originated (balance in small syndicates), with a bias to non-cyclical sectors, and counterparty diversification is achieved with its portfolio of 35 loans.

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	6.4%	6.9%	6.5%
Dividend cover (Hardman & Co basis, x)	1.0	1.2	1.2
NAV (p)	0.97	0.99	1.01
S/P premium to NAV	3%	1%	-1%
Loan book	102,581	130,000	245,000

Source: Hardman & Co Research

Premium Equity Closed-Ended Investment Funds



Source: Refinitiv

Market data

EPIC/TKR	**RMDL/RMDZ**
Price (p)	**99.5/105.5**
12m High (p)	103.0 / 106.0
12m Low (p)	99.5 / 101.5
Shares (m)	122.24
Mkt Cap Ords (£m)	122
NAV p/shr (p)	98.96 *
Free Float	100%
Market	LSE Equity Inv. Instrument

**including 0.51p gain in December*

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

(RM) +44 131 6037060
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'Jan	December factsheet

Analyst

Mark Thomas 020 7194 7622
mt@hardmanandco.com

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RMDL as alternative investment in social infrastructure

Background

Social infrastructure growing part of RMDL portfolio – now approximately a quarter of commitments

RMDL's 16 December factsheet announced a new ca.£6m social infrastructure investment to Uninn Group, to fund four operating student accommodation assets located across key university cities, Newcastle, Sheffield, Leicester, and Coventry as well as four further drawdowns to loans previously documented with two borrowers relating to student accommodation and receivables finance. Social infrastructure (defined by RMDL as health and social care, childcare and student accommodation) now accounts for 10 holdings with a total commitment of £33m (RMDL's drawn lending at end-November was £136m).

Gives investors an alternative exposure to this market

This is a growing area of focus for RMDL and, for investors, presents them with an alternative way to get exposure to this market. We conclude that RMDL: i) offers a higher dividend yield; ii) carries less downside risk and iii) introduces diversity and so reduced volatility compared with social infrastructure companies. It does not have the same equity-upside but offers a different portfolio option. As noted in our initiation, RMDL delivers its returns through high skill and service levels.

Offers higher yield, lower downside risk, non-correlated asset in exchange for potential equity upside

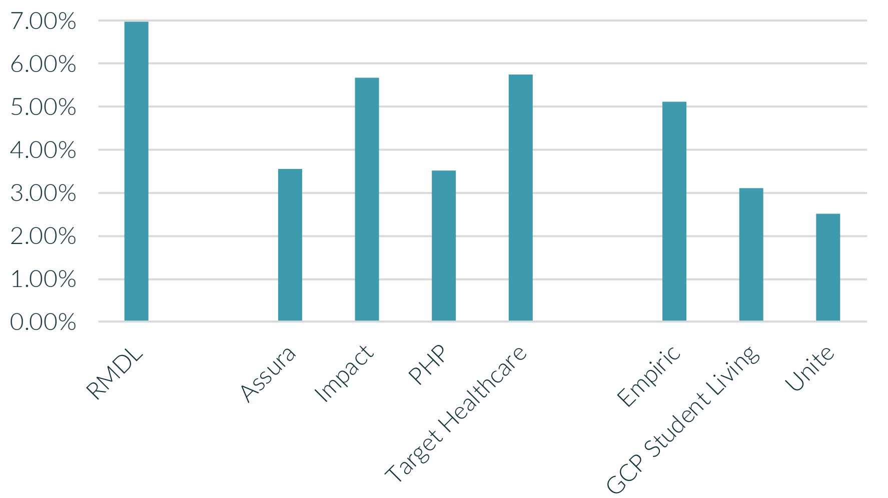
We believe it is important to understand why investors are in social infrastructure investments in the first place. We believe the primary driver is an income which is perceived to be secure, rather than capital gains. Assuming investors are seeking safety and downside protection, having an element invested in higher-yielding, lower-downside-risk RMDL appears sensible.

Higher dividend yield

RMDL yield, at ca.7%, is well above social infrastructure companies

The chart below shows the dividend yield from RMDL and a range of social infrastructure investment companies. We have not included in RMDL any further special dividends which may come from pre-payment gains.

Dividend yield (%) for RMDL and range of social infrastructure investments



Source: Company announcements, Hardman & Co Research, priced at 2 January 2020 working sheet a225

We note:

- Unite's RNS 8 October update states the USAF portfolio is valued at an average yield of 5.2% while the LSAV portfolio is valued at an average yield of 4.5%, which compares with up to 9% that RMDL earns on its student accommodation.
- PHP's interim 2019 results reported a 4.85% net initial yield.

With special dividends

Special dividends paid when extra income earned – typically from early repayments

RMDL has paid out two special dividends this year and will therefore comfortably exceed the target of 6.5p p.a. (6.5% yield). Net interest income for the year to end-November is 7.91p (as per latest factsheet) helped by early repayment related income. Investment trusts have to pay out a minimum of 85% of net income and this year we expect both special dividends and a small element retained to support future dividends.

For lower downside risk

Equity bears first loss so RMDL lower downside risk

RMDL is a lender and its exposure is to loans. Any losses in the social infrastructure customer would be initially borne by the equity holders in that business. Whatever the cause of loss, it would be borne by them ahead of RMDL. The vehicles above are where investors are investing in the equity of such businesses.

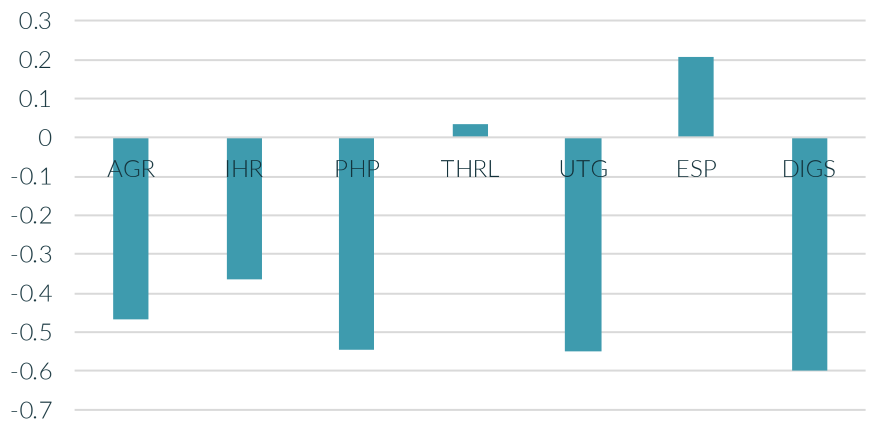
It is important to understand how RMDL achieves this risk/reward balance and we detail that in the section below.

From uncorrelated asset

Share prices is not correlated to other social infrastructure assets

It is no surprise the correlation between RMDL's share price and that of various social infrastructure companies is not statistically significant. By way of example, we have taken the three-year period from mid-December 2016 to 2019 and show the correlations below. This lack of correlation reflects the different asset class (debt against equity), diversification, relatively limited corporate action (e.g. PHP's merger with Medix) and RMDL's sector mix. There may be other factors (such as liquidity, share issuance) but as we are considering more than 750 data points, we would expect the effect to be limited.

Share price correlation with RMDL in past three years



Source: Alpha Terminal, Hardman & Co Research, social infrastructure

But no equity upside

We believe investors in social infrastructure seek secure income as higher priority than capital gain

Equity holders clearly benefit from the (geared) capital gains should the underlying assets increase in value. RMDL does not benefit from this to any meaningful extent, although it may see early repayment gains from rising capital values (which in 2019 are likely to be in excess of 1% return). However, we believe that, for most investors, the sector is more about having secure dividend than making material capital gains. By way of examples, we note the relatively modest NAV gains reported across a range of the companies:

Companies generally delivering limited NAV growth

- Empiric Student Properties reported NAV growth of 2.7% in the year to June 2019.
- Target Healthcare EPRA NAV increased 1.7% in FY'19.
- Impact Healthcare NAV increased 3% in year to June 2019.

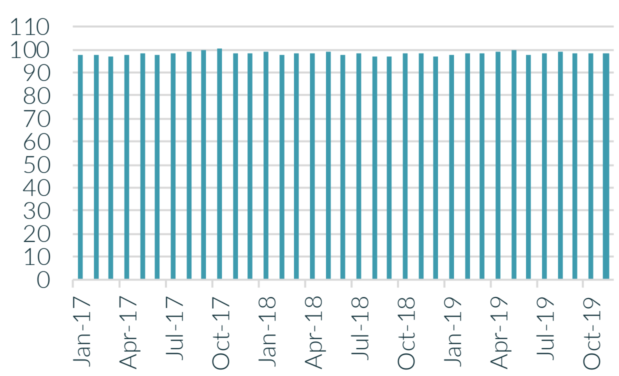
Wide range of share price performances

The actual share price performance for the social infrastructure funds under consideration here has been mixed. PHPO, has benefitted from the merger synergies with Medix and has risen by more than 100% since mid-December 2016. The average rise has been just under 20% with three in the 30%-35% range, Target Healthcare rising just 6% and one (Empiric Student Property) falling by more than 10%.

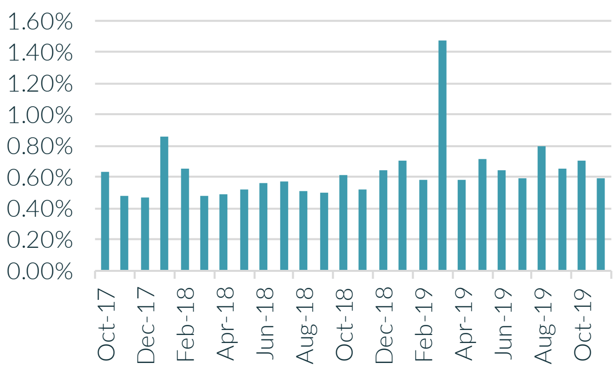
How RMDL achieves its returns

Before looking at how RMDL achieves its NAV, it is worth noting the results. The two charts below highlight: i) the incredible NAV stability RMDL has delivered despite using mark-to-market accounting standards; and ii) with the exception of one month with pre-payment returns, the incredible stability of net interest income, which is the key driver to the stable NAV.

Monthly NAV (p) since January 2017…



…Monthly net interest income as % NAV



Source: RMDL factsheet, Hardman & Co Research working sheet AK4 and j17

We outlined in our initiation, RMDL's competitive advantages and risks. In summary:

Limited competition in RMDL space

- 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.

Credit control a key skill

- 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.

Managers aligned to shareholders

- We note that the investment manager (RM) owns ca.0.8% of the company (nearly £1m invested), as it has reinvested 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.

Competitive advantages in origination

- We review 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 three quarters of book), and RM's approach to recoveries and arrears management. We also detail the current portfolio mix and compare it with peers. In addition, we consider the fee structure, for both the investment manager's fees and what the investors pay, together with the economies of scale noted above.

Cost of funds to a social infrastructure business is mix of all types of debt. RMDL earns incremental returns with skill and service

- We note that social infrastructure funds report a cost of funds which is materially below the level RMDL reports as income on its loans. By way of example, PHP reported in June an average cost of debt of 3.75% while Empiric reported 3.22%. The factors behind this include:
    - the reported cost of funds is a weighted average with debt structures being typically being 80%-85% senior (paying currently ca.2%) and 15%-20% junior (currently paying 9%+). 30% of RMDL's portfolio is junior debt.
    - There is an element of currency mix with some of PHP's debt denominated in **€** to match **€** assets.
    - RMDL is paid for its skills and service, which, for example, may include being able to accurately assess say the construction risk in a project and to structure debt around that. RMDL's flexibility in its structuring of debt is materially higher than say mainstream bank providers.
    - As noted above RMDL operates in part of the market which has less competition than many other areas of lending.

Other news

Early repayment gains/other gains

RMDL earns income from pre-payment of debt – not built into our earnings or dividend forecasts

RMDL reported on 16 December the early repayment of a $10.5m loan, the pre-payment proceeds of which added 0.51p to the NAV. This followed the 8 April announcement that two loans totalling £6.25m have been prepaid, which – with the associated sale of equity warrants issued to RMDL by one of the Borrowers – saw combined proceeds adding 1.3p to the NAV. In our numbers, we give no credit for early repayment penalties nor one-off gains because of their lumpy nature. However, such gains appear to be a feature of the business and management has indicated that they will be largely returned to shareholders by means of special dividends.

Why not a Hadrian's Wall

Different business model, culture, accounting and credit experience from Hadrian's Wall; no read across

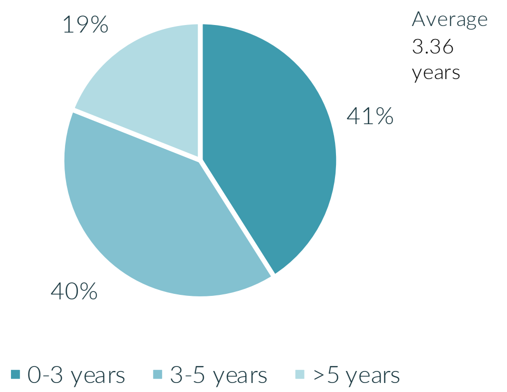
Hadrian's Wall Secured Investments (HWSL) reported on 9 December "that the Company is no longer continuing in its current form" following consultation with shareholders. This followed the announcement on 20 November of materially increased provisions against one exposure and a 27 June announcement of provisions against another. We believe that, in a concentrated portfolio, a marked deterioration of two investments leads to investors questioning both the credit processes and valuation techniques.

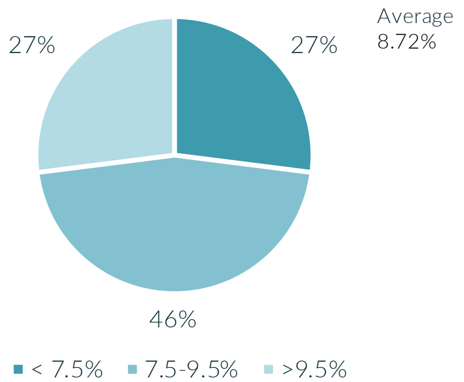
We do not believe there is any read across to HMDL (and its share price premium to NAV would appear to confirm this is also the market view). The reasons we have reached this conclusion include:

- HWSL has had a number of credit events to the larger loans within their portfolio – RMDL has to date demonstrated its ability to source and structure investments that have not had such events.
- Questions have to be asked about HWSL's recovery procedures as its recent portfolio updates suggest that expected recovery on the company's biomass investments will be minimal. Our discussions with RMDL indicate a robust approach to collections, which should further protect the downside and reduce losses.
- Disclosures: HWSL made limited public disclosures making it harder to value a significant proportion of its portfolio. RMDL has made significant shareholder disclosures and is a manager happy to clarify any investors' questions.
- RMDL adopts an independently marked to market valuation so perceived risks, in addition to known ones, should be factored into the NAV. The accounting policies which HWSL used were more model based and investors are likely to question the conservatism used in its assumptions. We have regularly highlighted the importance of culture in both running the business and accounting for it.
- We have outlined in this and previous notes how RMDL assesses, monitors and collects debt. Any lender is exposed to risk of unforeseen circumstances leading to credit losses and investors thus need to have comfort that both the probability of loss and the loss in the event of default is reduced and RMDL has such processes in place.

Latest portfolio analysis

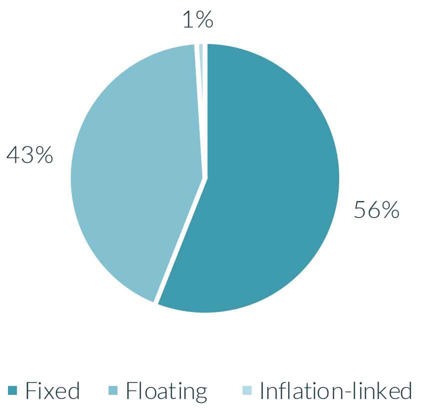
Portfolio mix by weighted average life (%)... / ...and yield (%)

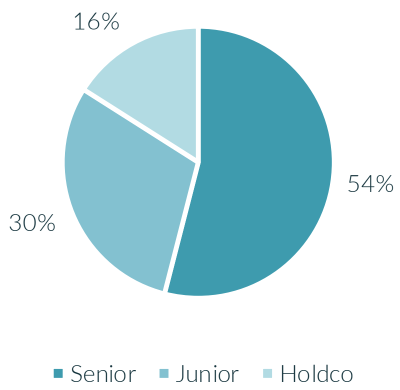




Source: RMDL July factsheet, Hardman & Co Research

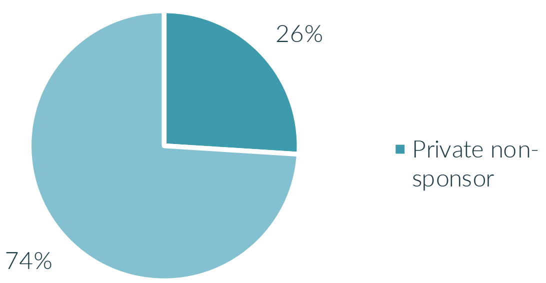
Portfolio mix by coupon type (%)... / ...and investment type (%)

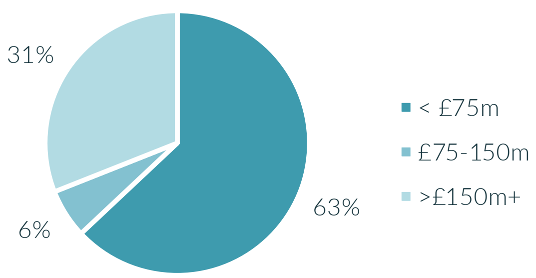




Source: RMDL November factsheet, Hardman & Co Research editors working sheet rows 123

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	4.09
Hospitality	8.50	9.00	4.35
Hospitality	8.30	9.00	4.35
Telecoms	8.11	11.23	1.65
Business Services	7.00	6.73	4.98
Forecourt Operator	6.70	4.87	2.62
Automotive Parts Manufacturer	6.63	12.00	3.08
Gym Franchising	6.30	8.29	6.68
Healthcare	6.00	6.50	5.35
Student Accommodation	5.68	9.00	0.85

Source: RMDL November factsheet, Hardman & Co Research

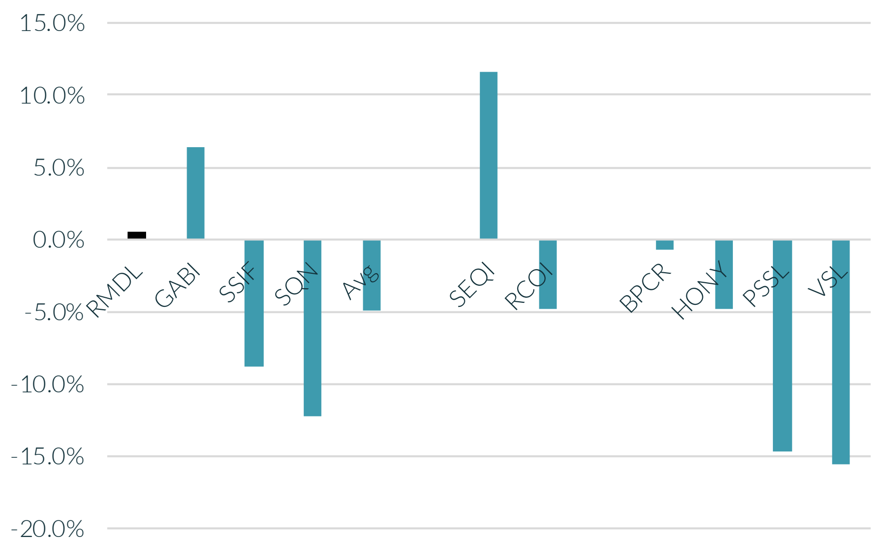
Valuation

RMDL on small NAV premium to close peers

In the chart below, we compare the premium/discount to NAV of RMDL with its immediate peers (tickers: GABI, 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 AIC sector. As can be seen from the chart, the average rating for the close peers is a 5% discount to NAV. RMDL's 0.5% premium is thus better than average, but only modestly so, and it is not the largest premium.

Hadrian's Wall is in wind-down so we have removed it from the peer comparisons. We have also included SEQI, which focuses on infrastructure and RCOI, which invests in global energy senior secured loans. 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. 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 2 January 2020 sheet valuation

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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

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research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com