# BDCs, quota shares and other big credit opportunities

PreserverPartners president and CIO Floyd Tyler sets out four big ideas his credit FoHF is spotting at present

The portfolio has strong income generation targeted at 6-8% per annum from diverse strategies without excessive credit, interest rate or macroeconomic risks. Our focused portfolio of uncorrelated risk exposures invests thematically in structural market inefficiencies and opportunistically in temporary dislocations.

While we see several private market areas of interest, the volatility in August and September is well on its way to creating temporary dislocations in public markets.

## Senior securities of business development companies

The opportunity in business development companies (BDCs) is growing after dismal returns over the last two years. BDCs have struggled since early 2014 due to investor concerns of rising rates, exposure to the energy sector, the removal from several equity indices, and greater risk aversion around deal terms and asset quality. Rising rates increase the cost of leverage and can have a negative impact on asset prices. Competition for deals has been reflected in tighter yield spreads, and weaker covenant packages, while new industry lending verticals and the use of off-balance sheet entities have increased perceived risks.

BDCs primarily provide capital to private middle market companies in the form of secured loans, debt and equity. There are more than 30 publicly traded BDCs with a combined market capitalisation of $18bn. BDCs must distribute 90% of their investment income and maintain a diverse portfolio of no more than 5% of assets in a single security and no more than 25% in a single sector. The average BDC trades at a discount to book value and a discount to normalised five-year valuations. Dividend yields range from 6%-18%. The higher yields reflect higher risks. The better management teams have limited shareholder dilution and leverage, while promoting asset quality, high net income to shareholder equity and shareholder-friendly fee structures.

The true impact of higher rates on BDCs may be exaggerated. Most BDCs hold floating rate loans, while the cost of capital is primarily fixed rate, thus gross margins rise as rates increase. In addition, if rates are rising, it is likely that the economy and corporate credit are improving. Our base case is for an extended period between rate hikes and lower terminal level of Fed funds rates than the market consensus.

We like the senior debt and cumulative preferred equity of internally managed BDCs with investment-grade ratings, positive ratings outlooks, high cash dividend coverage, and accretive share repurchase programmes. Debt and preferred shares are required by Section 18 of the Investment Company Act of 1940 to have asset coverage ratios of 200% of outstanding debt reducing balance sheet risk. The price volatility and potential for dividend cuts if the economy or interest rate environment changes increase the risk of the common equity. Attractive investment candidates are Harvest Capital Credit Corp 7% 1/16/20, and Oxford Lane Capital 8.5% Series Term Preferred Stock.

## Municipal CEFs

Investor rate hike fears and overreaction to high profile, troubled municipal credits have created opportunities in municipal securities. If purchased at a meaningful discount with a high coupon, intermediate-term duration securities can perform reasonably well during a gradual rate normalisation process.

Tax-exempt bonds are yielding more than taxable bonds at similar maturities. Municipal credit quality has improved materially since the financial crisis despite headlines about Puerto Rico, Detroit and bankruptcies in smaller cities.

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Interest rate risks tend to be higher due to longer maturities. Municipals are the largest closed-end sector. Some municipal closed-end funds such as Nuveen Municipal Income are down 4%-7% year-to-date through 24 September, while the underlying securities have risen 2%-5% this year.

These are some of the widest share price to net asset value disparities since 2008. Most closed-end end bond funds do not have exposure to Puerto Rico and those that do have approximately 1% at the end of May.

We are finding closed-end funds with significantly wide discounts (5%-6%), tax equivalent yields over 7%-8%, high undistributed investment income and limited leverage. The rationale for limited leverage CEFs is to reduce volatility around financing risk and asset prices.

It is important to keep in mind that short-term muni rates are low (around 10-15 bps). If the Federal Reserve increases short Treasury rates, muni rates may not move by an equivalent amount. Also, long muni rates are almost always greater than short rates, mitigating the cost of leverage. In anticipation of volatility and reduced liquidity at times, our investment approach is buy and hold.

Attractive investment-grade municipal CEF candidates include Nuveen Municipal Income and Western Asset Municipal High Income.

## Financing for transitional and secondary market US real estate

Favourable commercial real estate fundamentals, attractive valuations for transitional properties and the exodus of commercial banks from bridge lending have created sizable opportunities for debt investors.

Commercial banks are no longer the primary capital sources for higher risk loan segments due to regulatory rules. The inclusion of these CRE loan segments in stress tests and the CCAR process discourages banks from these loan segments.

During the 2015 stress tests, cumulative CRE loan losses reached 8.6% of total CRE loans, compared to 6.1% for all loans. Recent regulatory changes, such as Basel III's increased capital requirements for banks, Dodd-Frank's risk retention rules for securitisation sponsors and Office of the Comptroller of the Currency (OCC) rules around leverage also reduce the appetite for CRE loans.

A benign economic backdrop for commercial real estate means strong credit performance on current loans and rising equity values. With over $1.4trn of CRE debt maturities through 2018, there will be ample refinance and investment opportunities. Credit spreads are wide enough to generate attractive levered returns. Risks are increased competition that leads to yield compression and loosening underwriting standards or an economic recession, which seems unlikely at present.

In public real estate equity, commercial mortgage REITs are an overlooked equity segment that can be used to express a positive view on commercial real estate lending.

They invest in commercial mortgages and loans, CMBS, mezzanine loans, subordinated securities, construction loans, and loan securitisations. There are only 13 publicly traded companies with $32bn in total assets. We are finding select names to be attractive with 5-8% dividend yields, 10-15% net returns on equity and positive debt rating trends. Attractive commercial mortgage REITs include Blackstone Mortgage Trust and Ladder Capital.

In private real estate markets, we see opportunities in short-term bridge loans and mezzanine debt for transitional properties and direct equity in value-add properties in secondary real estate markets and in non-core property types. There remains wider than normal valuation gaps in cap rates between primary and secondary markets.

Cap rates in secondary markets can be 300-500 bps higher than primary markets across property types. The loans are typically used for property acquisition, construction and redevelopment. Loan maturities are typically one-year and available gross yields are 9%-12%. The equity investments in secondary markets are typically used for property acquisition and redevelopment. The unlevered gross yields are 6-7% with capital appreciation potential as cap rate spreads normalise and property fundamentals remain favourable.

## Quota Shares (Reinsurance)

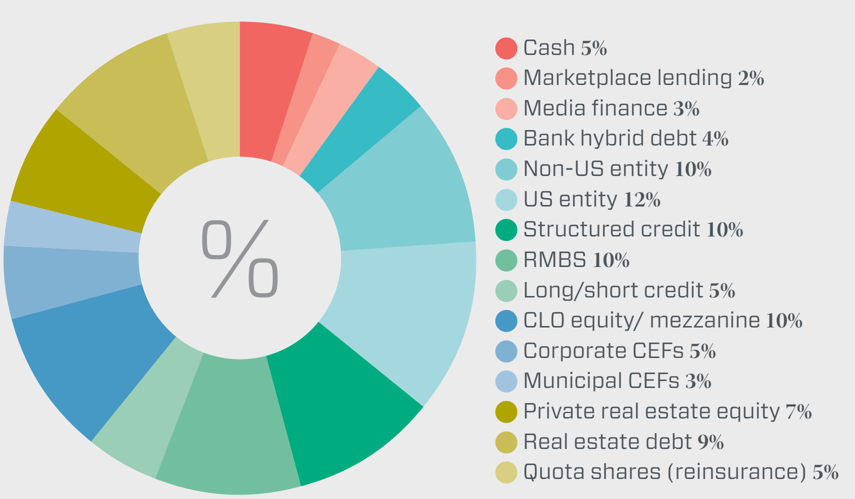
Given Preserver's hunt for uncorrelated yield, reinsurance and insurance-linked securities are a part of our investment universe. Prospective returns to public market insurance-linked securities are increasingly challenged by the significant inflows from alternative and third party capital, increased retentions by ceding companies and the lack of significant major and catastrophe losses in recent years.

Rather than investing in reinsurance hedge funds that directly compete with reinsurers or common equity of publicly traded reinsurers, we have invested in quota shares structured as pari-passu transactions, which allow reinsurers to leverage third party capital enhancing scale and scope, while sharing risk. Quota shares allow investors to participate in a specified transaction or portfolio underwritten by a reinsurer. Investors receive a pro rata share of the reinsurer's premiums and pay the same share of the losses from claims. If there are no claims or claims are less than deductibles and contractual risk retentions of individual policyholders, investors keep the entire premium.

Quota shares provide short-duration and diversified reinsurance exposure across a broad universe of perils including hurricanes, earthquakes, windstorms, typhoons, aviation, marine, floods, and other catastrophes available in liquid, catastrophe bonds. Gross premiums can range from single to double-digit yields depending on the peril.

***Floyd Tyler is president and CIO of PreseverPartners***

## Portfolio allocation




THE $35M FUND IS UP 0.69% YTD