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Victory Park Specialty Investments

Update
11 October 2019

Summary

Victory Park Specialty Investments (VSL) lends to sponsor-backed alternative lending companies, using its specialist knowledge of the sector to generate an average coupon of 11.84% from asset-backed loans, with low impairment rates and strong performance in stress-tests. The 8p a year dividend, paid quarterly, is now almost 100% covered by interest income and fully covered by NAV total returns. The yield is 10.2% on the current share price, with the trust trading on a 14.8% discount.

VSL acts as a 'lender to lenders', with its loans secured against the loans made by the portfolio companies and with significant first loss protection provided by the borrowers. These are primarily consumer loans, to US, UK and Latin American borrowers. There are also loans made to SMEs, but these make up only 15% of the portfolio. The loans are structured in such a way that VSL monitors the health of the investee's balance sheet on a monthly basis, and can demand further capitalisation if impairments rise, or take control of the loan book to pay back their investment in extreme circumstances.

The company is something of a turnaround story. When launched, it invested in unsecured marketplace loans and securitisation in addition to a portfolio of balance sheet loans, but after impairments in this new field were higher than expected refocused the company to a balance-sheet only model more in line with the expertise of the manager, Victory Park Capital.

VPC is a specialist lender to sponsor backed companies, in particular fintech. It operates at scale, with VPC having committed and invested more than $7bn across more than 50 companies in the financial services sector. VSL, at £297m net assets, can therefore participate in much larger deals negotiated by the manager, which are allocated largely pro rata across its various funds and accounts.

The portfolio is concentrated, with 43% in the top four positions, although underlying the 22 total debt investments are over 1.8 million individual loans. On a look-through basis, the total gearing is 43%, with the company having drawn down a facility worth roughly 16% to lever up its largest investment, in Elevate Credit. Elevate Credit is now a public company having IPO'd on the NYSE in 2018 and is the manager's longest standing portfolio company, with a lending relationship of nearly a decade and consistently strong performance.

Portfolio

VPC Specialty Investments (VSL) acts as a 'lender to lenders', extending credit to innovative finance companies, which are increasingly taking the place of banks in lending to businesses and consumers. The majority of the portfolio, 85% on a look-through basis, is invested in consumer loans, with the remainder invested in loans to small businesses.

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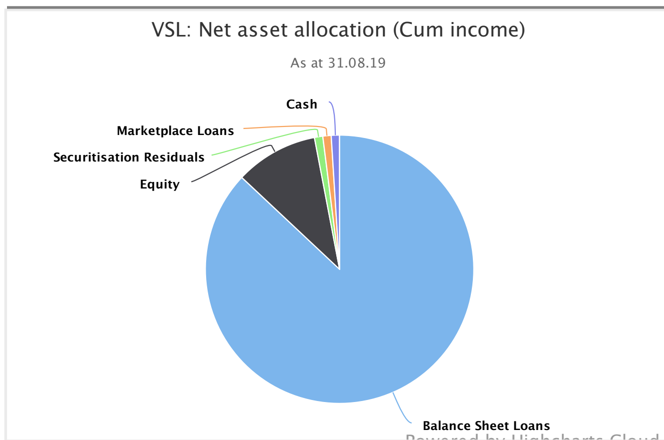
VSL lends to technology companies mostly formed since the financial crisis, and is therefore in a young industry which is poorly understood by non-specialists. As a result, it is able to ask for high rates of return on its loans. The weighted average coupon on the portfolio is 11.84% (as of the end of August 2019). Loans are floating rate, with the manager negotiating floors on the coupon, which should protect income return if US LIBOR was to fall below 1% (as it last did in December 2016).

VSL concentrates on balance sheet loans, which are secured against the total assets of the borrower – the majority of which are the underlying loans. Aside from these balance sheet loans, there is a 10% weighting to equity, and residual allocations to marketplace loans and securitisations, in which the company no longer invests new money and which generate moderate current yields.

Fig.1: Asset Allocation



Source: Victory Park

As early-and medium stage companies, the investees are typically fast-growing, and this has consequences for the trust. First, it means that positions can grow to a substantial percentage of NAV quite quickly. This helps explain the concentrated nature of the portfolio, with over half the portfolio lent to four borrowers. Secondly, it means the rates on the loans typically come down as the company progresses and increasingly has other options for funding. The manager ensures it has the right to match the offer from any alternative lender, but also has the right not to match the lower rate and withdraw, which may happen as the business becomes more mature.

Both consequences are illustrated by a key balance sheet investment: the company's largest position is a 15.2% holding in Elevate Credit. Elevate Credit is a non-prime lender which serves consumers in the US and UK with poor credit scores who have difficulty in borrowing money except at extortionate rates. Through the use of sophisticated modelling, it is able to offer a more affordable alternative to payday loans – the rate on its loans is under a third of the average payday loan rate in the US.

Top Ten As At 31/07/19

INVESTMENT	GEOGRAPHY	% OF NAV
Elevate Credit	United States	15.23
Caribbean Financial Group	Caribbean	12.66
Applied Data Finance	United States	10.91
West Creek Financial	United States	4.56
NCP Holdings	United States	4.24
Konfio	Mexico	4.18
Counsel Financial Holdings	United States	3.98
Keller Lenkner	United States	3.7
Borro	United Kingdom	3.19
Oakam	United Kingdom	3.05

Source: Victory Park

Victory Park Capital is the largest source of debt financing to Elevate Credit. A $250m line of credit extended in 2014 has grown to $563m (as of the end of 2018). As Elevate Credit has grown and become a more established and proven business, the rate VSL charges has come down, with the rate now 7.5% above the bank rate, with a floor at 1%. This compares to an average of roughly 12% in 2018 (Kepler calculations). To retain its position in this successful business while maintaining the income for shareholders, VSL has levered up its investment.

The second-largest position, in Caribbean Financial Group (CFG), is worth 12.7% of NAV. CFG provides consumer loans in the Caribbean, with a focus on Panama, and Trinidad and Tobago. The company's track record dates back to 1979, and the worst year for losses on its book saw just 5.9% charged off (during the 2008 financial crisis). Applied Data Finance, which makes up 10.9% of NAV, operates a similar business to Elevate Credit, offering short-term loans with quick decision times via an online interface, Personify Financial.

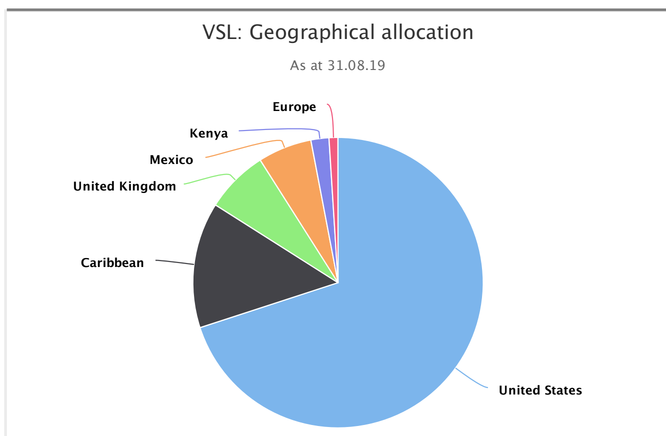
The equity position has diverse components consisting of 27 individual investments, some of which are warrant positions (derivatives which give the right to buy or sell at a fixed price) received for free as part of a larger credit transaction. In addition to its warrants positions, VSL will sometimes invest a small amount alongside the sponsors as part of a larger transaction to benefit from helping the business scale. This offers the trust extra upside should the business be successful. The 10% allocation has a cost basis of 8.3% and also includes positions taken as a part of the restructuring of two positions in less successful investments, and some exercised warrants. CFG, Deinde

Group and Elevate Credit are the largest contributors to the equity bucket.

The company also has four remaining investments in market place loans (where the platform doesn't take the underlying loans onto its balance sheet and so the loan is unsecured) and securitisations. These make up only 2% of NAV and are being wound down but are currently generating modest income. In the early years of its life, investments here were a significant part of the portfolio. However, they were something of a departure from the core business of VPC, which is the balance sheet model described below, and after the sector started to perform poorly, the manager has reverted to its preferred style of investment.

The vast majority of the lending is made in dollars, including the CFG investment. The majority of foreign exchange exposure is hedged.

Fig.2: Geographical Exposure



Source: Victory Park

The structure of the loans and risk management

Loans are structured in a highly advantageous way to the lender. This is clearly critical when the underlying loans are unsecured and, via some significant positions, are being offered to those with poor credit scores.

Typically, VSL extends a line of credit to the borrower, agreeing to lend against a percentage of its assets (dubbed the borrowing base). The collateral is valued conservatively, on a cost basis, and historical analysis of cashflow timing and impairment patterns is undertaken, with the loan book stress-tested against extreme scenarios. The LTV is calculated using the company's loss ratio, which results in a typical cushion of 1.5 to 2 times the amount lent. There is also an equity tranche, which should absorb the typical impairments expected in normal market conditions.

As the borrower grows its loan book and its collateral, it may draw down more of the debt. If the business shrinks or there are impairments, the amount which VSL will lend falls, and the borrower must pay back any excess. The borrowing base is reviewed on a monthly basis, giving a high degree of visibility to VSL on the strength of the underlying loan book. Should the borrower be unable to bring the collateral back to above the agreed limit, VSL can take ownership of the assets and run them down. In addition to the direct collateral of the borrowing base, the investments also have collateral in the form of excess cash and other assets (known as boot collateral).

As noted above, concentration at the top level is somewhat expected since the more successful platforms will continue to grow and draw down additional capital from VPC. However, on a look-through basis there are over 1.8 million loans. Given Victory Park can take ownership of the loan book once impairments mount, the true diversification becomes apparent.

The proof of the pudding is in the eating, and VSL has had to run off a couple of investments in this way in the past. In both cases it expects 100% recovery of principal extended, with the risk mitigation mechanisms doing their job. Most recently, UK lender Oakam was placed in administration in February 2019. As its loan portfolio was run off, it was used to pay down the company's investment, and Oakam successfully exited administration in June with a capital infusion from new investors and resumed issuing loans. The cash on cash multiple for VSL's investment in Oakam is 1.14 times as it stands, albeit with much of that unrealised at the present time. This indicates how an investee company can still generate positive returns for VSL in some circumstances thanks to the security built into the structure of the loans. In the 2017 financial year, the company took a 49% equity stake in Borro as a part of a recapitalisation plan with a cost basis and carrying value of zero. The business is still being run off.

While this illustrates the low chance of losing money on the original investment, it does not mean that the yield could not be threatened should there be impairments. High levels of impairments would reduce the income-earning assets and therefore affect the yield on the portfolio. Similarly, if all the positions in the portfolio were to have the success of Elevate Credit, then the yield it provides would be significantly diminished. A pipeline of potential new investments is therefore crucial to the long-term viability of the dividend. Victory Park has a pipeline of approximately $1.4bn in unfunded investments. The maturity profile of the business can be seen below, with little needing to be reinvested until Q4 2020.

With the majority of the investments being in 'consumer loans', one risk to be considered is the performance of the asset class in a recession. According to analysis done by

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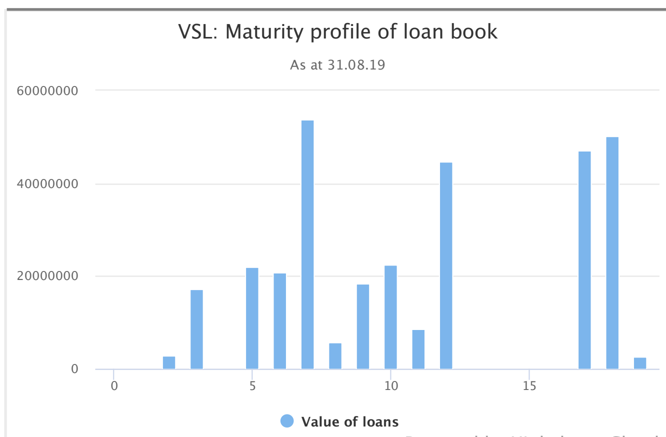
2nd Order Solutions (2OS), the type of non-prime loans issued by the portfolio companies actually suffer very little deterioration in their performance during recessions. Because borrowers with poor credit scores are usually only lent to on a very short-term basis, existing loans are by and large paid off and new lending curtailed before the recessionary environment has developed far. Data from 2OS shows that subprime loans have displayed much lower increases in delinquencies than near prime or prime. For example, in 2008, the losses to subprime personal loans increased by only 16%, compared to an uptick of 41% for near prime and 108% for prime. This pattern is borne out in the results of Elevate Credit, VSL's largest investment. During the crisis years there was very little variation in loss rates, with charge-offs ticking up from 18% to 19.8% between 2006 and 2007 before falling to 17.7% in 2008 and 17.6% in 2009. By comparison, the credit card industry suffered a more than doubling of charge-offs between 2006 and 2009.

Fig.3: Maturity Profile



Source: Victory Park

Detailed and rigorous due diligence is essential in this specialist area. VSL invests alongside other portfolios managed by Victory Park Capital, a specialist in lending to alternative financing companies. Once a candidate investment is identified, the due diligence involves a site visit of three to five days which involves Victory Park analysts plus outside accounting firms scrutinising the accounts and operations of the business, at the cost of the borrowers. The whole process of validating the accounts and hammering out the term sheet takes two to four months.

Investments are typically allocated pro rata across the different funds and accounts run by Victory Park. The scale of the firm's investments brings advantages in terms of the resources it can bring to bear on due diligence.

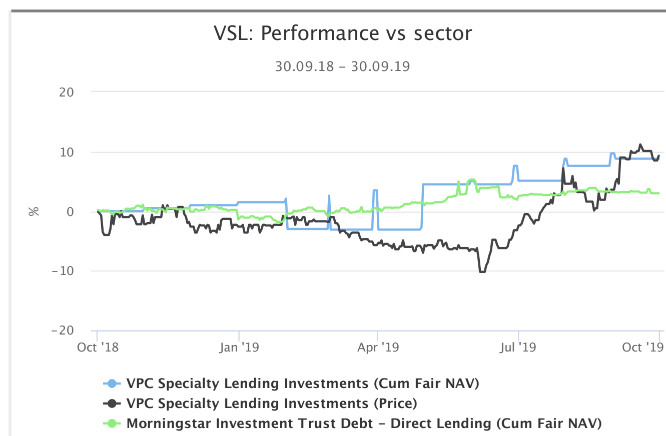
Gearing

The company has a $75m borrowing facility with CapitalSource, of which $57m was drawn down as of the end of Q2 – roughly 16% of NAV. The company's articles of association prohibit it from a look-through gearing ratio of 150% or above, but in practice the level has been much more modest. With the addition of the CapitalSource borrowing, it rose to 43% at the end of August from 16% at the start of the year and 17% at the start of 2018.

Performance

Returns over the past year show the benefits of the refocusing on balance sheet loans. The trust has generated NAV total returns of 8.8% since launch, compared to an average 3% for the Morningstar Direct Lending sector average. Shareholders have enjoyed a total return of 9.2%. Over the same period the FTSE All Share has risen just 1.8%.

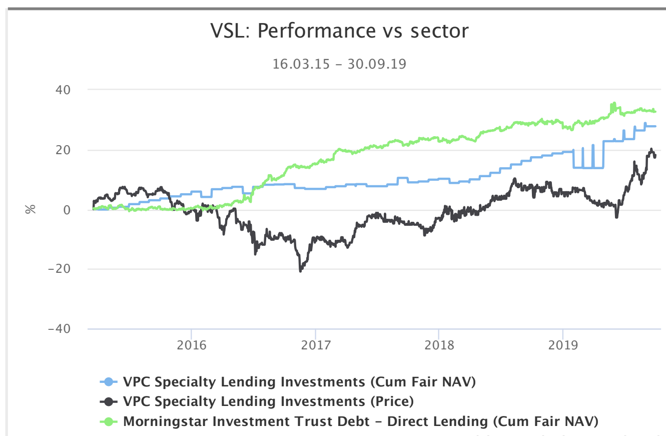
Fig.4: One-Year Performance



Source: Morningstar

Since launch, the company has generated NAV total returns of 27.8% to the end of September 2019, according to Morningstar data. This compares to an average return in the Morningstar Debt – Direct Lending sector of 32.7%.

Fig.5: Performance Since Launch

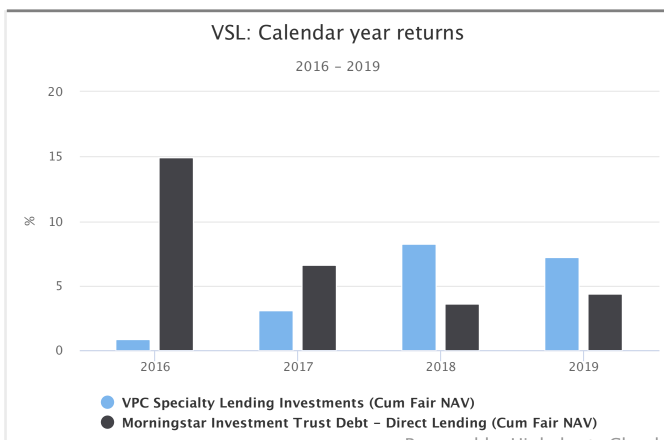


Source: Morningstar

Solid income performance (+33.92% to end July 2019), particularly from balance sheet loans, has been offset somewhat by capital losses. The marketplace positions have been a small positive on a total return basis (+1.15%), although have brought capital losses of 6.42%. The securitisation positions have reduced NAV total returns by 5.32% over that period, while the balance sheet loans have returned -1.68% in capital terms.

Total returns in 2016 and 2017 were disappointing, following the underperformance of the marketplace loans and securitisations. The refashioning of the portfolio began in 2016: at the start of that year the top five investments were marketplace loans, and there was 58% invested in this structure overall. At the end of the year, four of the top five investments were balance sheet loans, and the allocation to that bucket had risen from 22% to 51%, with marketplace loans falling to 26%. In January 2018, the investment in Borro was also written down as it was recapitalised, with Victory Park taking a major equity stake.

Fig.6: Returns



Source: Morningstar

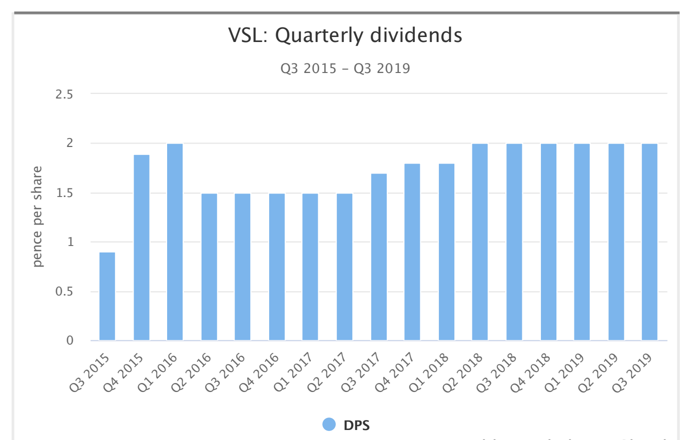
Returns in 2018 reflect the greater potential of the refashioned balance sheet loan book. This began the year as 79% of the overall portfolio and ended it as 85%. The company's investments overall generated a revenue return of 11.4% net of costs, fully covering the dividend. Total returns were reduced by hedging costs as well as small capital losses (1.45% across the different structures of investments). This year, 2019, has seen the strong performance continue, with a record quarterly NAV return of 3.97% achieved in Q2. Hedging has continued to reduce total returns.

Dividend

The high yield is a chief attraction of the company: it pays a quarterly dividend of 2p a share. The 8p full year dividend is equivalent to a yield of 10.1% on the current share price, which is trading at a 14.8% discount to NAV.

The 2p quarterly dividend is a target since launch. Impairments on the marketplace loans made early in the company's life led to a dividend cut in 2016; it was brought back to the target level in Q2 2018. The balance sheet loans performed in line with expectations and generated higher returns, with the marketplace loans underperforming. The reallocation to balance sheet loans has therefore allowed the company to hit its income targets. By our calculations, last year's 8p dividend was covered 1.3 times by the net income from the portfolio last year.

Fig.7: Dividends



Source: AIC

Management

VSL is managed by a team at Victory Park Capital, which is made up of private capital managers with particular experience in operating within the fast-growing alternative finance sector. VPC, founded in 2007 by Richard Levy and Brendan Carroll, has invested nearly $8.5bn since inception. It has operated in this sector – providing financing in lieu of bank debt to middle market companies – since 2010, and as of the last annual report had provided financing to 50 companies in the financial services sector. Most of these deals have been the delayed draw balance sheet loans as described in the portfolio section. VSL invests pro rata across the relevant opportunities provided by the team alongside the other funds and segregated mandates managed by VPC.

The ten senior members of the partnership have an average of 15 years' experience in a relevant field. The 15-member investment committee includes several members with experience in distressed debt and corporate turnaround lending, which helps when portfolio companies experience difficulties and should reduce the losses suffered in adverse scenarios. Meanwhile, the manager also employs a further 15 people in risk management and

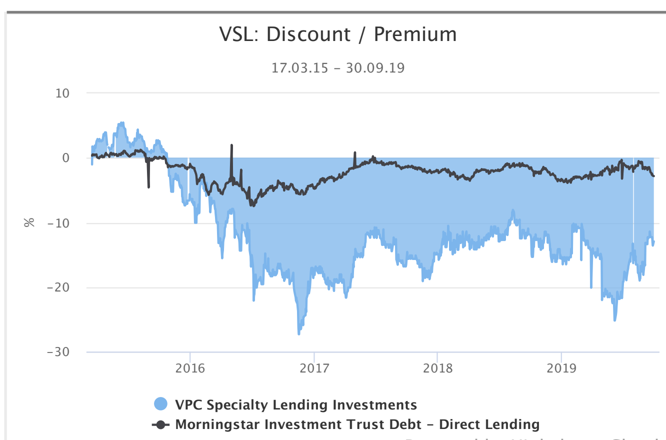
operations, allowing them to manage the complexity of the mandate of VSL. VPC are based in Chicago, with offices across the US.

Discount

VPC trades on a discount of 14.8%. When it launched in April 2015, the platform lending space was popular among investors and therefore the trust's shares traded on a premium. The portfolio looked very different at that time, being concentrated in marketplace loans and securitisations rather than direct balance sheet loans. As sentiment changed towards the alternative finance space, it fell out of favour dramatically, and VPC fell onto a wide discount (>25%).

However, since 2017 the portfolio has been completely revamped to be in line with Victory Park Capital's main line of business – balance sheet loans, lent directly to companies rather than via platforms. The discount, however, was stubborn. Partly this reflects technical pressure; during 2019 Neil Woodford has sold his 16.6% stake in the company. There was also a mistake made by FTSE Russell in July, which led to the company being erroneously excluded from the FTSE All Share and then reinstated, which may have caused some short-term volatility.

Fig.8: Discount



Source: Morningstar

The board has employed buybacks to attempt to close the discount, while the investment manager has also been reinvesting 20% of its management fee in the shares each month. In total, the company has repurchased roughly 61 million shares since inception, or 16% of the share capital.

Charges

The OCF is 1.49%, compared to an average figure of 1.87% for the platform lending companies which JPMorgan Cazenove tracks. This includes a 1% management fee paid monthly, with a provision that there be no double charging if the company invests in funds or SPVs, which are already paying a management fee to Victory Park Capital. There is a performance fee, worth 15% of the NAV total return performance, subject to a hurdle rate of 5% and a high water mark provision (based on 30 April 2017 NAV). If a fee is not earned in one calendar year, the period is deemed to be continuing, and the fee will only be paid if at the end of a future year the hurdle rate and high water market provisions have been met. By our calculations, the NAV total returns from 30 April 2017 to the last month end (July 2019) have been 6.4% per annum.

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