QuotedData

Update | Investment companies

6 September 2016

The SME Loan Fund (formerly GLI Alternative Finance)

Steady progress in turbulent times

The SME Loan Fund (SMEF) has been one of the best-performing funds in its peer group in NAV terms since it was launched. It is focused on lending to small and medium-sized enterprises (SMEs), an area which in the experience of the UK investment companies market to date, has proved to be less prone to defaults than consumer lending. The board and the manager are keen to close the discount and expand the fund. They point out that investors buying today can, if they wish, exit part of their holding at NAV less 0.5% in March 2017. The board may also consider buying back stock beforehand.

As SMEF approaches the anniversary of its launch, the manager believes it has demonstrated the robustness of its diverse lending operations. The board and the manager have refined SMEF's investment approach to prepare it for expansion and believe it should be a multiple of its current size.

Attractive risk-adjusted returns from SME loans

SMEF has an investment objective of providing its shareholders with attractive risk-adjusted returns through investment in a range of SME loan assets, diversified by asset class, geography and duration. SMEF may invest directly or indirectly in available opportunities, including by making investments in, or acquiring interests held by, third-party alternative lending platforms and other lending-related opportunities as identified by the manager in accordance with the company's investment policy.

Period ended	Share price total return (%)	NAV total return (%)	Peer group average price TR (%)	Peer group average NAV TR (%)	Bank of England base rate (%)
31/07/16	(5.6)	7.6	(6.1)	6.6	0.4

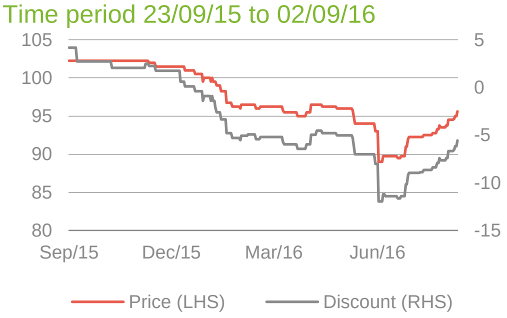
Source: Morningstar, Marten & Co

Sector	Debt
Ticker	SMEF LN
Base currency	GBP
Price	95.62p
NAV	101.26p
Premium/(discount)	(5.6%)
Yield*	7.5%

*Note: The yield is sourced from Morningstar.

Share price and discount

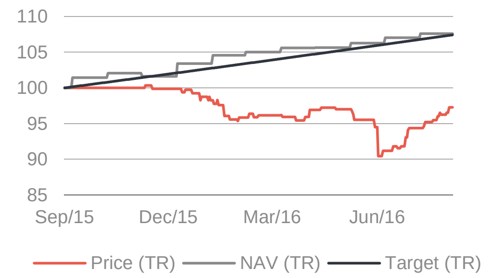
Time period 23/09/15 to 02/09/16



Source: Morningstar, Marten & Co

Performance since launch

Time period 23/09/15 to 02/09/16



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	23 Sep 2015
Manager	Graham Glass
Market cap (GBP)	50m
Shares outstanding	52.66m
Daily vol. (1-yr. avg.)	22,300 shares
Net cash	7.5%

Click here for our initiation note

Conflict of Interest

All QuotedData's sponsored research is written with a balanced, objective view, with the goal of enabling readers to make their own decisions.

Transparency is very important to us and so we would like to make you aware that one of the authors of this note, James Carthew, is also a director of GLI Finance Limited (GLI) and owns 300,000 shares in that company (but has no investment in SMEF). GLI is a co-owner of Amberton Asset Management Limited, which manages the fund and is also an investor in a number of the platforms through which The SME Loan Fund invests.

While James contributed some of the material for the note, this was edited by other Marten & Co authors and he was not involved in decisions on final content.

All change and no change

Further information on The SME Loan Fund can be found at the company's new website: www.thesmeloanfund.com

On the face of it, The SME Loan Fund (SMEF) has changed substantially since QuotedData published its initiation note on 17 November 2015. It has changed its name from GLI Alternative Finance; the asset manager also changed its name after its ownership structure was altered; the fund has sought and gained approval for a number of alterations to its investment risk limits; there have been changes to the make-up of the board; and there have been changes to the composition of the share register. However, SMEF's manager says that, at its heart, it is still the same fund, with the same ambitions and an almost identical investment process focused on the steady generation of yield, while seeking to maintain investors' capital.

The manager believes that, over the past nine months, SMEF has strengthened its foundations and demonstrated its superiority over larger rivals (see pages 6 and 7 for more detail). Its focus now is on eliminating its discount and increasing its size. In their view, the building blocks are now in place for this to be a much larger fund.

Name change

On 31 August 2016 The SME Loan Fund changed its name from GLI Alternative Finance and its ticker became SMEF. The manager says that this move reflects the new ownership structure of the fund's asset manager and the freedom that SMEF now has to invest in loans that did not originate on the GLI family of platforms.

Changes at the asset manager

SMEF's asset manager has been rebranded to Amberton Asset Management following the acquisition by the Somerston Group of a 50% stake in the asset manager

Fifty per cent of the asset manager has been acquired by Golf Investments, part of the Somerston group of companies (Somerston), and the manager has been rebranded as Amberton Asset Management Limited (Amberton). Somerston is a family office with considerable resources and experience.

Graham Glass was appointed to manage the portfolio on 21 March 2016. He is assisted by Martin Baxter (in charge of communications with platforms), Nick Diligent (who performs quantitative analysis on the portfolio) and Doric Steer (responsible for compliance). Amberton has been encouraged by its owners to consider itself independent of GLI Finance Limited. Chinese walls are in place between the two and Amberton advises that its decision-making regarding investments is totally independent.

Changes to investment risk limits

SMEF's managers say that its investment policy has been amended to loosen investment restrictions that were potentially too restrictive and counterproductive given the fund's current size

SMEF is not as large as it was intended to be at this stage. As a result, SMEF's board and manager became concerned that the investment risk restrictions built into the fund at launch were too restrictive and were potentially counterproductive. On 3 August 2016, shareholders overwhelmingly approved (99.92% voted in favour) the following amendments to the investment policy:

- The limit for individual credit risk for the 10 largest positions is 2.5% - this has been maintained. The limit for other positions was raised from 1% to 2% of the portfolio. The effect of this is to greatly increase the manager's ability to take on larger loans (many of which, the managers say, are better quality than smaller loans) without unduly limiting the diversification of the portfolio (it still has around 240 holdings).
- The minimum investment in short-duration assets (loans due to be repaid within less than six months) was raised from 10% to 20%, a 10% minimum investment in other maturity bands was scrapped and the maximum 40% allocation to short-duration assets was also scrapped. The effect of this, the managers say, is to increase liquidity within the underlying portfolio, which gives SMEF greater flexibility to manage its discount. The manager also believes that the change will increase the average credit quality of the portfolio.

Changes to the board

Richard Hills has taken up the role of chairman. Ken Hillen brings experience of other lending businesses. There are now three directors

Richard Hills replaced Norman Chrighton as chairman on 21 June 2016 and, at the same time, Ken Hillen was appointed to the board as a non-executive director. SMEF's manager says that Ken brings considerable experience of working within lending businesses to the board and strengthens its credit analysis capabilities. Nick Brind resigned on 22 July 2016 and there is no plan to replace him. David Stevenson, a respected commentator on investments who also heads up AltFi.com, remains in place. The board believes that three directors is an adequate number for a fund of this size and saving one director's salary will help keep the ongoing charges ratio down.

Changes on the share register

As part of the Amberton deal, Golf Investments acquired 15m shares in SMEF from GLI and undertook to buy a further 10m shares in the event that SMEF raised at least £20m via a C-share issue at some point before 5 February 2017 (subject to Golf Investments not ending up with more than 29.9% of SMEF's issued share capital).

SMEF unaffected by industry growth pains

The alternative lending market continues to expand and there is ample scope for the market to continue to grow.

The alternative lending market continues to expand with the Liberum AltFi UK Volume Index increasing by 4.4% in July 2016 alone (to £7.6bn). The manager says that there is strong demand for alternative finance assets and that there is a significant unmet demand for loans from creditworthy companies. This would suggest that there is ample scope for both the market and SMEF to continue to grow.

SMEF is producing annualised returns in the region of 8% with a low default rate

SMEF is steadily producing close to 8% annualised returns (9.3% gross yield less ongoing charges) in an environment where some of the other debt funds are struggling. SMEF's default rate has been 0.96% since launch and is well within its projections, which SMEF's manager says is a reflection of the strength of its loan underwriting. The manager considers that he is generating positive alpha for investors when he is able to deliver default rates below projections. It is not unusual for SMEF to reject loans proposed by the underlying platforms. The advent of a new accounting standard, IFRS9, may require funds in the sector to adopt a general provisioning policy against potential defaults across the whole portfolio. This may have an accounting impact but SMEF's manager says that it should make no difference otherwise.

SMEF is unleveraged and currently has no plans to introduce borrowing

Unlike many of its peers, SMEF is achieving its target yield without recourse to borrowing money (leverage). This does not mean that an element of leverage would not prove useful, in reducing cash drag for instance, but there are no immediate plans to put leverage in place.

SMEF's focus on SME lending is proving beneficial when funds exposed to consumer lending are struggling

SMEF's focus on SME lending is proving beneficial in an environment where funds with exposure to consumer lending are posting negligible or even negative monthly returns. Amberton is keen to highlight the distinction between the two end markets. SMEF's managers say that SME lending tends to characterised by better credit quality, higher underwriting standards (loans are assessed individually rather than against a quantitative (numbers-based) model) and more security (84.9% of SMEF's loans were secured at 31 July 2016 – see Figure 4), which increases the chances of making a full recovery in the event of a default.

SMEF plans to lend through some non-GLI platforms

While GLI has had its own well-publicised difficulties, the loans that SMEF holds that were originated on GLI's platforms have, on the whole, been of good quality. SMEF's manager says that it has had no shortage of potential investments available to it and he has been able to pick and choose which loans SMEF makes and which platforms it is prepared to lend through. In the manager's view, the forthcoming addition of a number of non-GLI platforms to SMEF's approved list only serves to strengthen SMEF's ability to deploy capital on attractive risk-adjusted returns.

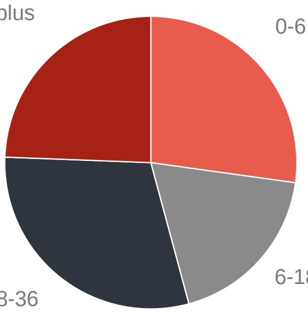
SMEF has a strong discount control mechanism in place

SMEF appears to have the strongest discount control mechanism amongst its peers. Shareholders have the chance to tender up to 20% of their holding at a 0.5% discount to asset value on 31 March 2017 and every six months thereafter. In addition, SMEF's board has the power to buy in shares at other times.

The two largest funds in the subsector, P2P Global Investments and VPC Speciality Lending, have not taken decisive steps to narrow their discounts, but SMEF's managers say that these funds relative inaction in this regard need not be seen as a sector-wide problem.

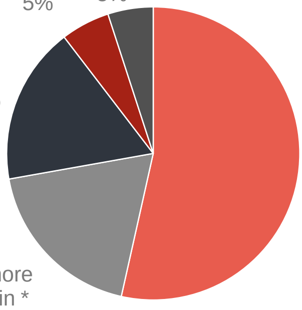
Asset allocation

Figure 1: Portfolio split by maturity as at 31 July 2016



Source: The SME Loan Fund

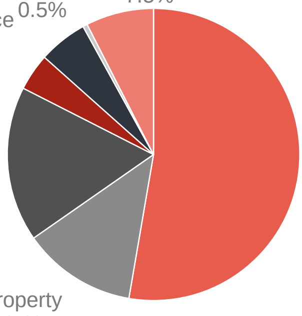
Figure 2: Portfolio split by geography as at 31 July 2016



Source: The SME Loan Fund. *Note: Offshore Britain includes the Channel Islands, Gibraltar and Isle of Man

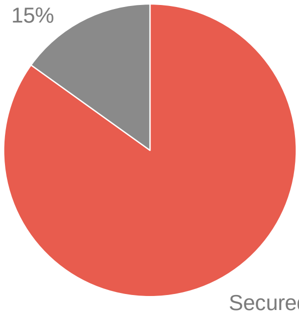
As can be seen in Figure 1, SMEF has a broad spread of loan maturities and while the portfolio has a bias to the UK, almost half of it is invested overseas.

Figure 3: Portfolio split by loan type as at 31 July 2016



Source: The SME Loan Fun. *Note: cash includes accrued income.

Figure 4: Secured versus non-secured as at 31 July 2016



Source: The SME Loan Fund

New loans in July came from five different platforms. These included two Spanish loans from Spanish peer-to-peer lending platform, My Triple A, building on six loans made in June. SMEF also underwrote two loans originated by UK Bond Network, benefitting from underwriting fees while being outbid for the loans themselves. SMEF's exposure to property loans fell as loans matured.

> At present, loans provided through Sancus have a zero rate of impairment

Sancus, the offshore lender, remains a key platform for SMEF. SMEF's managers say that its loans tend to have good security and low loan-to-value ratios. At present there is a zero rate of impairment on loans provided through Sancus.

The two BMS funds are a valuable source of loans for the fund. One is UK focused, with British Business Bank as a co-lender and the other, is focused on Ireland with the Irish Strategic Investment Fund as a co-lender.

Invoice finance deals are coming from Platform Black.

The exposure to FundingKnight loans fell as SMEF suspended lending when the platform seemed beset by money worries. SMEF's managers say that the loans SMEF had made through FundingKnight would not have been affected had the platform become insolvent as a back-up administrator would have managed out the book, nevertheless, SMEF felt it prudent to reduce its exposure at that time. SMEF's manager says that the rescue package put together by GLI has put FundingKnight on a more secure footing and SMEF is now considering FundingKnight loans again.

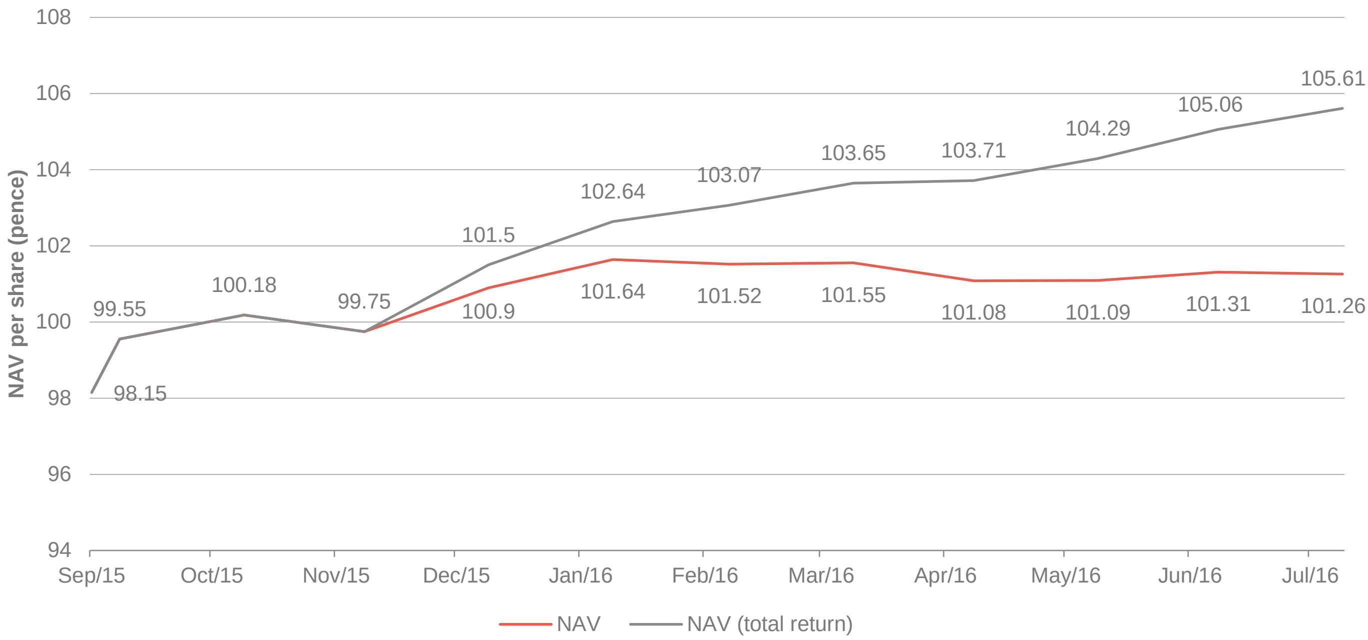
The manager forecasts cash flows and aims to minimise cash drag, but early repayment of loans or new loans falling at the last hurdle can occasionally cause the cash weighting to spike.

SMEF does not have equity stakes in the platforms through which it is investing. Working capital loans to platforms are reducing in importance

Unlike some of its peers, SMEF does not have equity stakes in the underlying platforms through which it invests. SMEF has previously made loans to some of these platforms to provide them with working capital. Going forward, SMEF will not be seeking to make such loans and is not renewing the existing loans as they mature. The manager expects the quantum of these loans to fall during the remainder of 2016.

Performance

Figure 5: NAV progression since launch

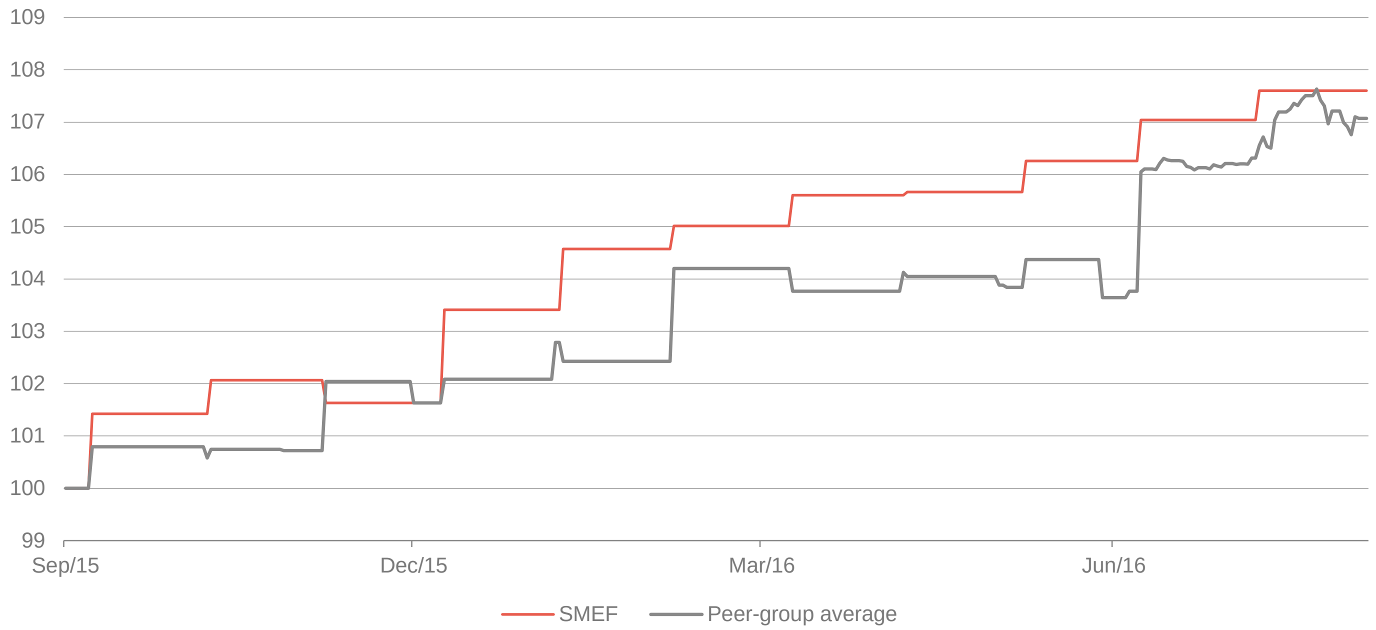


Source: The SME Loan Fund

SMEF invested the proceeds of its launch relatively quickly and income started to exceed expenditure just three months into the life of the fund (some of SMEF's peers were slower to get invested).

Peer-group comparison

Figure 6: SMEF NAV total return performance versus peer-group average



Source: Morningstar, Marten & Co

SMEF's NAV total return has outperformed the average of its peers since its launch - see our website for more detail

As Figure 6 shows, SMEF has outperformed the average of its peers since its launch. The peer-group average is skewed by the performance of Ranger Direct Lending (see Figure 7 which shows the make-up of the peer group). The vast majority of Ranger Direct Lending's assets are denominated in US dollars and the greater part of this is not hedged - consequently, the strength of the US dollar against sterling flatters its returns. SMEF is the smallest of the seven funds and trades on the third-widest discount. Its loan book is closer to that of Ranger and Hadrian's Wall Secured Investments (which are also focused on SME lending) than P2P and VPC Speciality Lending (which are more focused on consumer loans). With the exclusion of Ranger Direct Lending, its performance since launch is the best of the group. Ranger Direct Lending's factsheets show it has returned 7.3% in US-dollar terms between 1 October 2015 and 31 July 2016, implying that its underlying performance is similar or slightly behind that of SMEF.

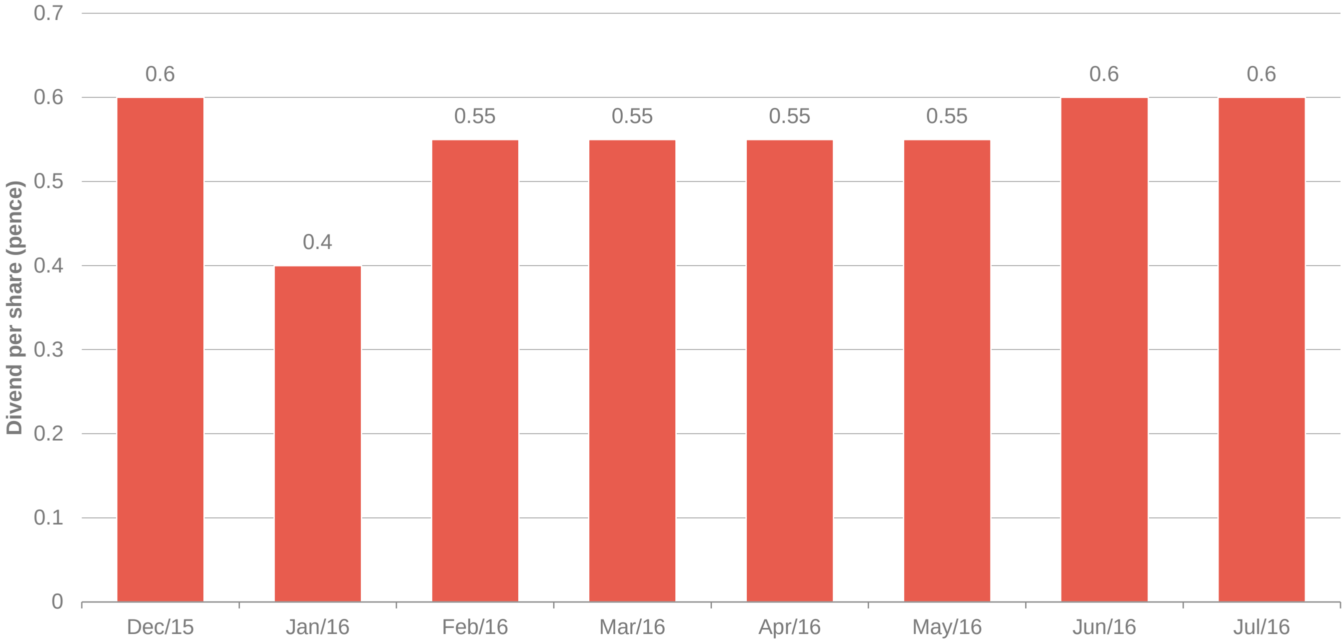
Figure 7: Peer-group comparison

Fund	Market cap £m	Premium/ (discount) (%)	NAV total return performance to 31/07/16 1 month (%)	3 months (%)	6 months (%)	Since 23/09/15 (%)
The SME Loan Fund	50	(5.6)	0.52	1.83	2.89	7.60
Funding Circle SME Income Fund	168	1.9	0.56	1.77	2.97	
Hadrian's Wall Secured Investments	85	8.7	(0.01)			
Honeycomb Investment Trust	152	0.1	0.68	2.26	3.12	
P2P Global Investments	699	(18.3)	0.07	1.15	3.43	4.21
Ranger Direct Lending	157	(5.9)	1.11	12.24	12.77	24.04
VPC Speciality Lending	308	(18.3)	0.33	0.30	3.59	4.73

Source: Morningstar, Marten & Co, The SME Loan Fund.

Dividend

Figure 8: Dividends declared since launch



Source: The SME Loan Fund

Previous research publications

Readers interested in further information about SMEF may wish to read our initiation note *Off and running*, published on 17 November 2015. The contents pages have been reproduced below. You can read the notes by clicking on the menu below or by visiting our website.

Off and running published 17 November 2015

4	**GLI's first fund**
4	**A lot simpler than it looks**
5	**The online lending market**
5	Figure 1: Global online lending market
5	Figure 2: Growth of online lending market in the UK
7	**About GLI Finance**
7	Figure 3: GLI's family of online lending platforms
7	**GLIAM's team**
8	The Credit Committee
8	**The demand for credit**
9	Figure 4: GLI estimates of monthly demand for loans on its platforms
9	**How GLAF is managed**

9	Credit approval
10	Monitoring loans and platforms
10	Defaults
10	Managing conflicts
11	Risk controls
11	Figure 5: Target maturity split
11	**Existing portfolio**
12	Figure 6: Geographic allocation at 31/10/15
12	Figure 7: Breakdown by loan type at 31/10/15
12	Figure 8: Breakdown by loan duration at 31/10/15
12	Figure 9: Breakdown by security at 31/10/15
12	Figure 10: Allocation by borrower type at 31/10/15
13	**Dividends**
13	**Fees**
13	**Capital Structure and Trust Life**
14	Suitability for retail investors
14	Future C shares
14	Hedging / Gearing
15	**Premium / Discount management**
15	Redemption facility
15	Continuation / Discontinuation
16	**The Board**
16	Figure 10: Board members
17	**GLI's platforms**
17	The UK Term Lenders
17	The US Term Lenders
17	Short-Term Finance
18	Trade Finance
18	Other
18	**Peer Group**
18	Figure 12: Comparison against three existing listed online loan finance co's
19	P2P Global
19	Figure 13: P2P Ord geographic split
19	Figure 14: P2P Ord loan type split
19	Figure 15: P2P Ord geographic split
19	Figure 16: P2P Ord loan type split
20	VPC Speciality Lending Investments
20	Figure 17: VSL Ord geographic split
20	Figure 18: VSL Ord loan type split
20	Ranger Direct Lending

20	Figure 19: RDL security split
20	Figure 20: RDL loan type split

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