EDISON

EJF Investments

2019 interims

Encouraging 2019 interims

Investment companies

EJF Investments (EJFI) delivered a 9.5% total return in H119. Despite the recent US rate cut receiving much attention, conditions remain supportive for US community and regional banks and insurance, whose subordinated securities support the US securitisation risk-retention investments that, along with related securities, account for 72% of EJFI's portfolio. Management remains optimistic on this asset class. In April EJFI redeemed a collateralised debt obligation (CDO) netting £8.9m in total, having earlier purchased one in March (forecast IRR 10–11%) and completed a further $11m investment in September.

H119: 9.5% total return

In H119 EJFI outperformed the S&P Leveraged Loan Index (which was up 5.7%). The fund paid a full 5.35p dividend and the NAV rose 6.7%. The redemption of the TFINS 17–1 risk retention investment in April added 9p (5%) to the NAV and was the key contributor to the return, underpinned by the solid performance of the portfolio in general during the half year. EJFI's $9.2m bridge loan to an insurance company affiliate was prepaid at par in July 2019, but EJFI was able to reinvest in a loan to the same issuer with a 12% coupon (previously 14%) and a 2022 maturity and it received a 2% commitment fee. The target dividend remains 10.7p per year.

Market environment

US community and regional banks and smaller insurance companies continue to benefit from the growing economy and favourable regulation. According to the FDIC, the average ROE was a robust 10.2% in Q119, with very low loan loss impairments and healthy balance sheets. M&A activity remained strong. However, the interest rate outlook is now less favourable: the Fed cut its policy rate by 25bp in July and markets are expecting another 75bp by the end of 2020, which will put some pressure on banks' interest income and therefore revenue. Equity investors are likely to be concerned with the potential earnings impact. However, from the point of view of a creditor like EJFI, we expect bank defaults to remain low due to their strong balance sheets, supportive regulation and resilient economic outlook.

EJF Capital extends support

During Q219, EJF Capital (EJF) decided to extend the period for which it is absorbing EJFI's 90% recurring operating costs (ex-incentive payments) from 1 July 2019 to at least 1 January 2020. In addition, a minimum 75% until the fund reaches £300m ($140.5m at 31 July). This shows the commitment and confidence EJF has in this asset class and the fund's management. EJFI announced in June that it will be starting a 12-month placing programme of up to 150m equity shares and/or up to 75m new zero dividend preference shares (the latter effectively debt).

Valuation: Discount to NAV

EJFI has traded close to NAV and has fluctuated between -3% and +2% since 2017. However, the NAV recently increased and EJFI is now trading at a discount of c 10% to the end-July NAV (adjusting for the 2.675p dividend paid in August) on no particular news.

8 October 2019

Price	**169p**
Market cap	**£108m**
NAV*	£123m
NAV* per share	189p
*At 30 August 2019	
Shares in issue	64.2m
Free float (estimated)	76.0%
Code	EJFI
Primary exchange	LSE – Specialist Fund Segment

Share price performance

%	1m	3m	12m
Abs	0.6	(9.8)	(6.8)
Rel (local)	1.8	(5.9)	(5.0)
52-week high/low		189p	168p

Business description

EJF Investments is an investment company seeking to earn risk-adjusted returns by investing in opportunities created by regulatory and structural changes affecting the financial services industry.

Next events

Next NAV release	October 2019

Analysts

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Edison profile page

EJF Investments is a research client of Edison Investment Research Limited

Exhibit 1: Company at a glance

Investment objective and fund background

EJF Investments (EJFI) seeks to generate attractive risk-adjusted returns by investing in assets benefiting from regulatory and structural changes in the financial services sector. These opportunities can include structured debt and equity, loans, bonds, preference shares, convertible notes and private equity, in both cash and synthetic formats issued by entities domiciled in the US, UK and Europe. Investments consist primarily of securitisation and related investments and specialty finance investments.

Recent developments

- 30 August 2019: new $11m investment announced in EJF-sponsored CDO.
- 23 August 2019: H119 results – NAV total return +9.5% vs S&P Leverage 5.7% and Credit Suisse West Europe HY Index 19.3%, all in £.
- 26 July 2019: 2.675p Q219 dividend declared, same as previously.
- 24 June 2019: beginning of 12-month placing programme of up to 150m shares and/or up to 75m new ZDP shares.
- 1 May/13 June 2019: EJF Capital agreed to absorb 90% of EJFI's recurring cost ex-management and incentive fees until no earlier than 1 January 2020 and no less than 75% thereafter of costs until NAV reaches £300m.

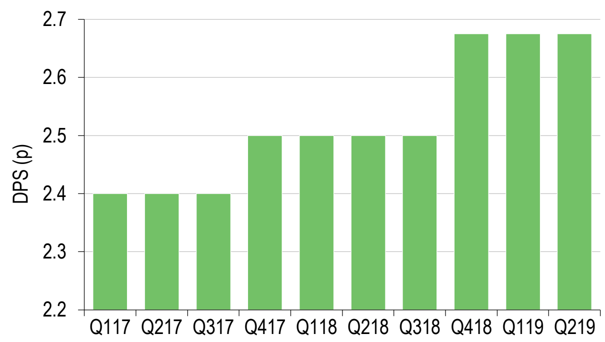
Forthcoming		Capital structure		Fund details	
AGM	June 2020 est.	Ongoing charges	2.2% (H119), 0.9% w EJF rebate	Group	EJF Investments
Annual report	April 2020 est.	Gross debt % NAV	18.5%	Manager	EJFI Manager
Year end	31 December	Annual mgmt fee	1%	Address	47 Esplanade St Helier, Jersey JE1 0BD
Dividend paid	May, Aug, Nov, Mar	Performance fee	10% over 8% IRR hurdle rate and high watermark*		
Launch date	7 April 2017	Company type	Closed-ended	Phone	+44 20 7901 8328
Continuation vote	Yes	Loan facilities	US$ credit facility	Website	www.ejfi.com

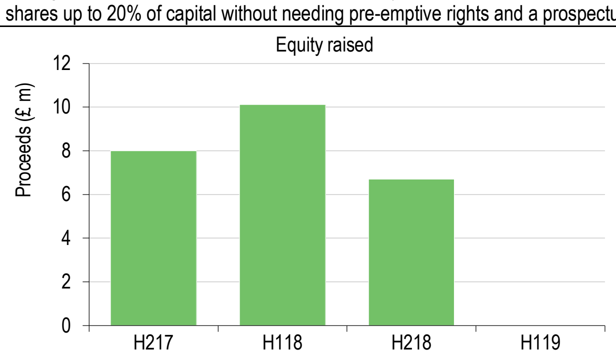
Dividend policy and history

EJFI pays dividends quarterly; this was increased from 2.5p to 2.675p in Q418. EJFI now targets a dividend of 10.7p annually, paid quarterly.

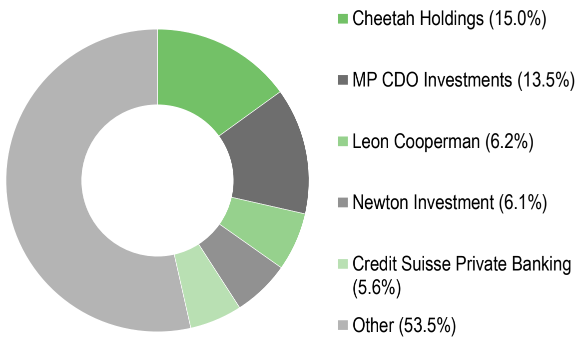
Share buyback policy and equity funding history

Management has authorisation to buy up to 14.99% of ordinary shares. Management obtained approval at the 14 February EGM to be able to issue shares up to 20% of capital without needing pre-emptive rights and a prospectus.

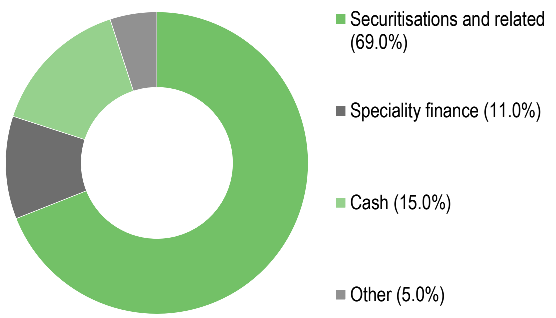




Shareholder base (at 30 September 2019)



Portfolio exposure by asset class (at 31 August 2019)



Top holdings

Holding	Asset category	Description	% of portfolio value	
			31 Jul 2019	31 Dec 2018
EJF sponsored CDO equity	Securitisations	Collateralised by US community and regional bank/insurance	51.3	52.6
EJF CDO Manager	Securitisations	49% stake, co-owned with EJF. Manages collateral in EJF securities	8.4	7.0
TruPS CDO bonds	Securitisations	Not EJF sponsored, bought in July 2018	6.3	8.3
Bridge loan	Speciality finance	Bridge loan affiliate of US listed insurance company, 2022 maturity	6.4	6.7
US bank subordinated debt	Securitisations	Eligible for future securitisation	4.3	4.3
Armadillo	Speciality finance	Lending to US law firms engaged in mass tort litigation	3.8	4.7
Other assets	Other	N/A	5.2	1.8
Cash	Cash	Restricted and unrestricted cash	14.3	14.7

Source: EJF Investments data. Note: *Manager uses proceeds to buy EJFI shares.

Fund profile: Regulation providing opportunities

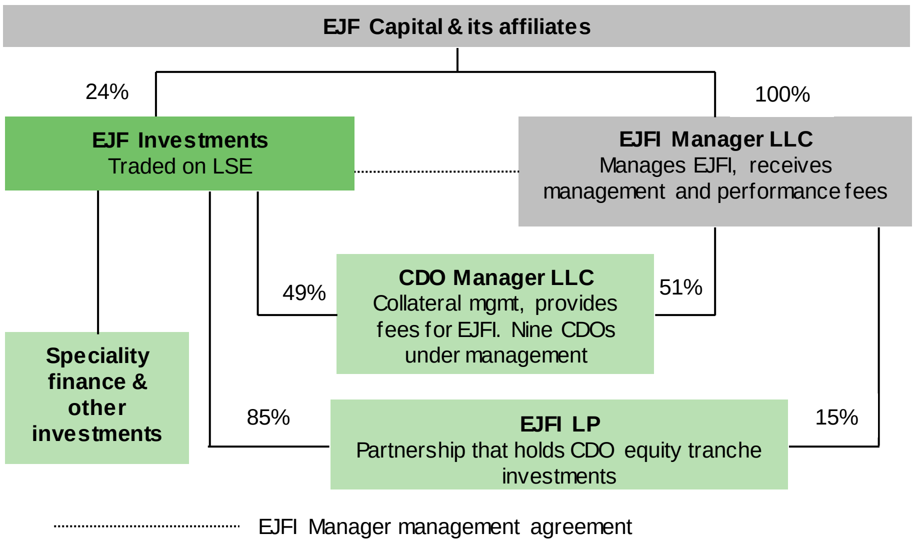
EJFI is a Jersey-domiciled, closed-end investment company admitted to trading on the Specialist Fund Segment of the LSE. Its manager, EJF Investments Manager (EJFI Manager), is wholly owned by EJF Capital (EJF), a US-based alternative asset manager with a presence in London. The fund was admitted to trading on 7 April 2017. EJFI invests in opportunities created by regulatory and structural changes affecting the financial services industry. The target investment range is broad and may include structured debt and equity, preferred shares, loans, bonds, convertibles and private equity. Assets are overwhelmingly in the US at present, but its geographic targets are the US and Europe. The fund targets an 8–10% NAV total return, including dividends. The dividend target is 10.7p per annum, paid quarterly.

EJFI's biggest focus is on the equity tranches of CDO securitisations backed by trust preferred securities (TruPS) as well as exposures and other related debt securities of US community and regional banks and insurance companies; these account for over 70% of the portfolio. EJFI's portfolio also includes non-bank specialist lending opportunities – for example it has a bridging loan to an affiliate of a listed insurance company and higher-yielding collateralised loans to law firms in the Armadillo portfolio, which is no longer core and is in run-off.

EJFI is authorised to have a gross debt to NAV ratio of up 35% but long-term leverage may not be more than 30% of NAV. EJFI has a short-term loan facility that can be accessed if there are short-term liquidity needs; to date this facility has not been used.

We also note that considerable effort and financial investment has been made to align the interests of EJFI, EJFI Manager and EJF. These include c 24% ownership of EJFI shares by principals and affiliates of the manager. EJF retains a minimum 15% stake in the EJFI Partnership (the EJFI vehicle that invests in the risk-retention tranches). To date, 100% of equity issued by EJF-sponsored CDOs is owned by EJFI and/or EJF-managed entities; CDO Manager is co-owned by EJFI and EJF; EJF covered all of EJFI's launch costs and will cover 90% of recurring operating expenses until at least 1 January 2020 (excluding management and incentive fees) and at least 75% of the same costs until the fund NAV reaches £300m; and there is a strategic link between CDO origination at the EJF level and the co-investment in the risk-retention tranches.

Exhibit 2: EJFI structure



Source: EJFI. Note: Parcel organisational structure excludes certain subsidiaries.

CDO equity investments remain the core

Management believes the risk-return profile of CDO equity tranches remains appealing and that prospects continue to be underpinned by favourable regulatory and economic tailwinds. Legislation has simplified capital rules for these regional and community banks and made stress testing less onerous. Capital formation has also been made easier, which helps encourage merger and acquisition activity between these banks.

EJFI is gaining leveraged exposure to bank debt by buying CDO equity tranches collateralised by their debt. The investment opportunity is also driven by the 2010 Dodd-Frank Act requiring securitisation sponsors to retain 5% of their own securitisations to better align themselves with clients. EJFI acts as a partner to EJF in EJF's CDO securitisations, purchasing these risk-retention investments structured as the equity tranche in the CDOs. The relationship with EJF gives EJFI privileged access to these securities through rights of first refusal on the 5% retention plus 49% of the collateral manager, which results in yield pick-up from the additional management fees. So far, all seven CDO equity tranches have been EJF sponsored, but EJFI is not restricted from investing in other sponsored securitisations, or from being a sponsor itself. The disclosed estimated IRRs of the CDO equity tranches (one was called in April 2019 and the seventh just completed in September) are attractive, ranging from 8.4% to 13.3%. Most of the underlying collateral in the securitisations is floating rate, so it is attractive in a rising interest rate environment. The securitisations, including the five risk-retention investments, some legacy CDOs, a US bank sub-debt investment together with EJFI's investment in the CDO Manager account for 72% of EJFI's portfolio value at end-July 2019.

Differentiated CDO strategy

CDO securitisations are typically structured into three or more tranches: senior debt, mezzanine and equity. If the collateral does not perform, the equity tranche absorbs the first losses. Deals are typically over-collateralised and residual gains eventually benefit the equity tranche. EJFI buys into the equity tranche of these CDO securitisations at a minimum of 5% of the deal total market value, which represents the risk-retention requirement. European compliance is also satisfied as required. The risk-retention requirement is the amount that regulation obliges securitisation sponsors (or related companies) to retain of their own securitisations. Although CDOs may be backed by a range of debt classes, those in which EJFI invests are subordinated debt mostly in the form of TruPS (hybrid equity/debt instruments).

EJFI has a differentiated, selective approach to its CDO equity investments. First, it focuses on the investment-grade US financial sector where balance sheets are now more robust as a result of structural changes following the financial crisis in 2008/09 and subsequent economic growth, and where smaller and medium-sized US banks are specifically boosted by regulatory relief legislation. The investments are floating rate. EJFI investments are also relatively lower geared (1.6–6.7x) where some securitisations' gearings can reach 9–10x. EJF-sponsored securitisations typically give investors more clarity at the point of investment on the expected return and risk exposure because the CLO Manager is usually not able to reinvest the inflows (ie static pools). However, the last securitisation investment in September was a departure from this since it does allow potential M&A driven gains to be reinvested. This is because management sees this as an opportunity for higher returns given the outlook for M&A activity. Finally, we note that EJFI can count on the support of EJF and its resources, including an experienced team of 84 professionals.

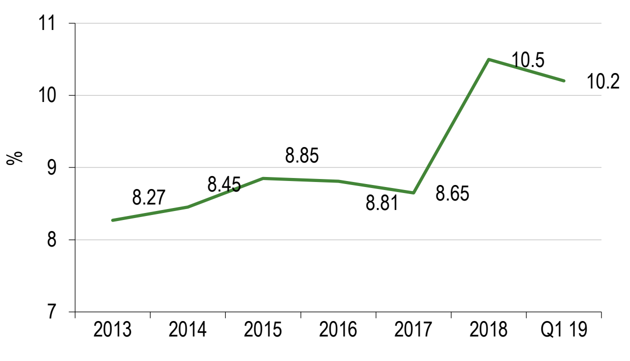
US community bank update

The latest figures from the Federal Deposit Insurance Corporation (FDIC) show US community banks and insurance companies continue to do well. Profitability remains good, balance sheets are healthy and merger and acquisition activity is strong.

The US community bank average ROE was a robust 10.2% in Q119 according to the FDIC. The net interest margin has remained stable at 3.67% compared to 2018, whereas loan loss provisions were very small at 9bp. This is lower than the average in the wider US financial sector (123bp). Loans more than 90 days overdue also remain low and stable at 0.77% and equity is 10% of assets. US community banks' earnings were up 10% y-o-y, driven by interest income (+6% y-o-y) and lower impairments. The pace of M&A activity remains good with 115 deals (according to S&P Global Market Intelligence) in the first half of 2019 compared to an annual average of mid-200s in recent years. The US insurance market has also benefited from rising interest rates and economic tailwinds.

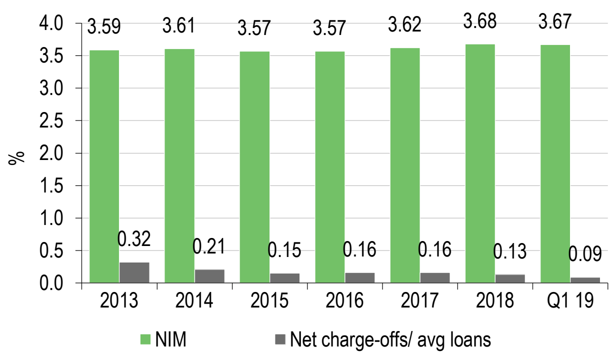
A challenge now is that the interest rate cycle has changed. The Fed cut its policy rate at the end of July by 25bp to 2.00–2.25% and the market is pricing in another 75bp by the end of 2020. This will put some pressure on profitability because interest income still accounts for most banking and insurance revenue. Clearly this is a concern for equity investors. The issue is less critical for credit investors since banks have been strengthening their balance sheets and shoring up their capital ratios in recent years, and this should help them withstand the margin pressure. Exhibit 4 clearly shows how low the charge-offs are relative to average loans. The average bank assets to equity ratio remain healthy at only 8.7x. The outlook is also still supportive of the banks and insurance companies, with the IMF forecasting US GDP growth of 2.6% in 2019 and 1.9% in 2020, while unemployment (a major driver of impairments) is forecast to remain at very low levels of below 4%. Therefore, while earnings are likely to be affected, bank default rates are likely to remain low in the foreseeable future. Furthermore, EJFI management believes the pressure on margins arising from a flatter yield curve may prompt increased M&A activity in response to this revenue challenge and this means greater prepayment of TruPS.

Exhibit 3: US community banks' RoE (%)



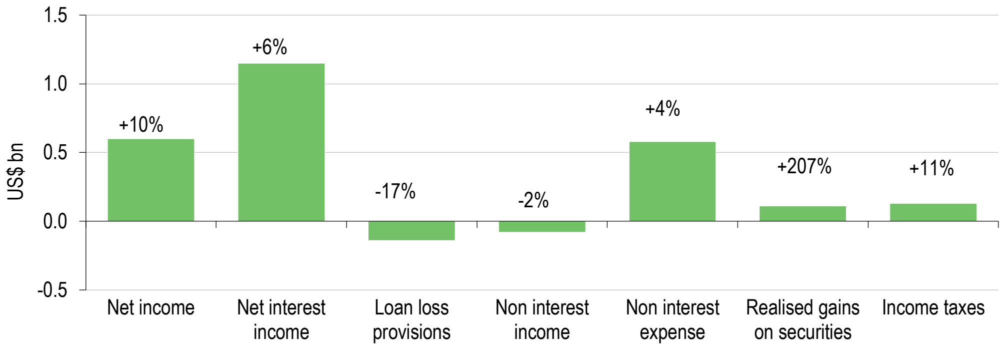
Source: FDIC. Note: 2018 figures are annualised.

Exhibit 4: US community banks' net interest margins (NIM) and net charge-offs (%)



Source: FDIC. Note: 2018 figures are annualised.

Exhibit 5: US community banks' year-on-year income drivers (Q119)



Source: FDIC. Note: Percentage numbers are year-on-year

Exhibit 6: US economic forecasts

(%)	2017	2018	2019e	2020e	2021e
GDP growth	2.2	2.9	2.6	1.9	1.8
Unemployment	4.4	3.9	3.6	3.5	3.6
Inflation	2.1	2.2	2.4	2.6	2.2

Source: IMF (July 2019)

The risk-retention investments

EJFI has bought seven EJF risk-retention investments: three in 2017, two in 2018 and two so far in 2019 if we include the one just completed in September. Six of them remain in the portfolio after one was called in April 2019 following strong performance and prepayment activity. All comprise the equity tranche of the respective CDOs.

The risk-retention investment added in March 2019 was similar to those previously purchased. It was backed by a mixture of banks and insurance TruPS with a 3.2% yield above Libor (previous investments ranged from 2.7% to 4.0% above Libor). The projected IRR is 9.7–11.3% (9.9–16.1% for the other investments) and the leverage averaged 4.6x (1.6–6.7x previously). EJFI collects the usual collateral management fee (20bp) and the current yield is 10.1% including the management fees. Like the others, the securities are callable two years after their closing dates, with mandatory auction dates eight years after the closing date.

The seventh investment was announced on 30 August 2019 and was completed in September for $11m. The collateral is mostly community and regional banks' subordinated debt rather than TruPS, and the whole CDO has par value of approximately $250m. This investment is the first where the CDO is primarily backed just by bank subordinated debt instead of TruPS and this has a growth potential for EJFI as TruPS are a legacy finance instrument for banks since the financial crisis.

Exhibit 7: The current risk-retention CDO investments

	TPINS 2016 Restructuring	TFINS 2017–2	TFINS 2018–1	TFINS 2018–2	TFINS 2019–1
Deal date	Dec 17	Oct 17	May 18	Dec 18	Mar 19
Collateral overview (on closing date)					
Banks/insurance split of collateral	0–100%	51–49%	93–7%	79–21%	62–38%
Collateral principal balance ($m)	327.2	353.0	537.8	351.0	313.9
TruPS/subordinated debt	100%	97%	99%	99%	91%
Floating rate	100%	89%	93%	100%	91%
WA collateral yield	Libor + 4.0%	Libor + 3.1%	Libor + 2.7%	Libor + 3.0%	Libor + 3.2%
Implied rating	Ba2	Ba1	Baa3	Baa3	Baa3
CDO Structure (on closing date)					
Weighted average cost of debt	Libor + 2.0%	Libor + 2.3%	Libor + 2.1%	Libor + 1.9%	Libor +2.5%
Leverage ratio	1.6x	4.3x	6.7x	5.7x	4.6x
Non call date/auction call date (mm/yy)	Apr-19, Apr-24	Sep-19, Sep-25	Mar-20, Mar-26	Dec-20, Dec-26	Feb21, Feb-26
Estimated return profile					
EJFI – CDO equity amount ($m)	13.4	16.1	22.7	17.5	15.7
Current Yield	9.50%	12.30%	11.30%	9.00%	8.60%
Current Yield w/ CDO mgmt fee	10.90%	13.10%	12.30%	10.50%	10.10%
Management fee	20bp	10bp	20bp	20bp	20 bps
IRR range (YTM – YTC)	11–12%	12–16%	12–13%	10–11%	10–11%

Source: EJFI

Sensitivities

The key risks and sensitivities are:

- Regulatory changes could affect the group structure and the investment opportunities.
- Market conditions might constrain further capital raising and thus limit the reduction in the expenses ratio.
- Almost all assets are level three and although position pricing is obtained from third-party brokers, an accurate determination of prices may not always be easily achievable.
- Despite having robust corporate governance measures and alignment of interests between EJF, EJFI and EJFI Manager, there is a risk that conflicts of interest may affect investment decisions, such as deal allocations.
- Banks and insurers tend to be cyclically sensitive and therefore exposed to changes in the economic growth outlook.
- Negative interest rate risks could affect security valuation and investment opportunities.

Strong H119

EJFI's total return for the first half of 2019 was 9.5%. The NAV per share rose by 6.2% from 178p per share to 189p at the end of August 2019 and EJFI paid 5.35p in dividends, maintaining its target annual dividend of 10.7p (a 6.3% yield on the current share price).

The performance highlight of the first half of 2019 was the call and redemption of the TFINS 2017–1 CDO in April. This resulted in a total return of £8.9m for EJFI, with a £5.8m gain in April alone worth 9p (5%) to the NAV and a key contributor to performance.

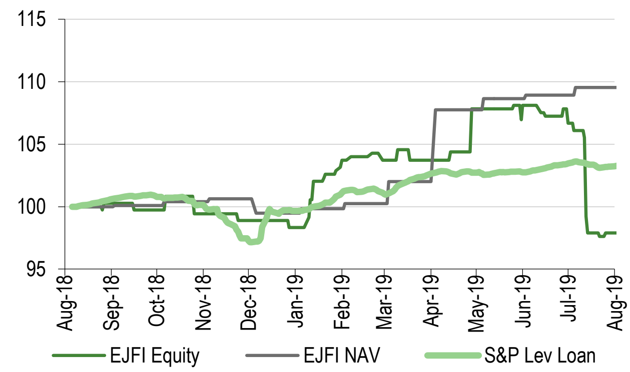
The month before, EJFI purchased its sixth EJF-sponsored CDO, investing $15.7m with a forecast IRR of 10–11%. A seventh CDO investment was recently completed in September. This investment is the first where the CDO is backed entirely by subordinated debt, as opposed to TruPS. This is a potential growth market for EJFI since while banks are generally not issuing new TruPS, subordinated debt remains a major and growing asset.

EJFI's $9.2m bridge loan to an insurance company affiliate was prepaid at par in July 2019 but EJFI was able to reinvest in a loan to the same issuer with the same terms and a 2022 maturity. EJFI received a 2% commitment.

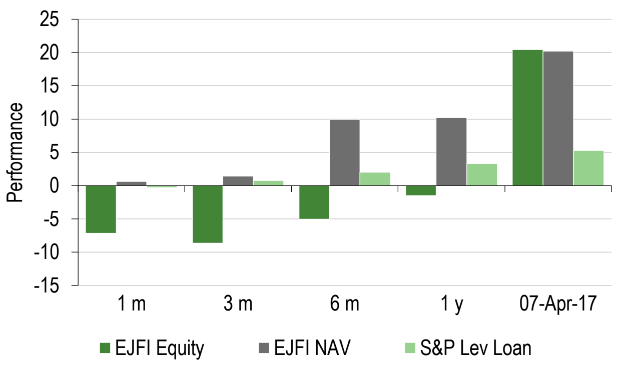
EJFI's high-yield lending portfolio to US law firms engaged in mass tort litigation (the Armadillo portfolio), which is in run-off in line with expectations, was stable in H119 after the write-downs in the previous half and represents just 4% of total assets.

Exhibit 8: Investment company performance to 31 July 2019

Price, NAV and index, total return performance, one-year rebased



Price, NAV and index, total return performance (%)



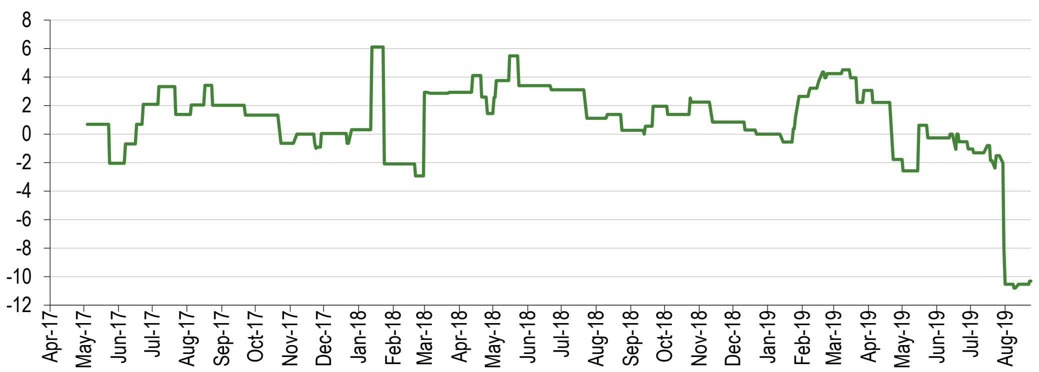
Source: Refinitiv, Edison Investment Research. Note: *Annualised.

Exhibit 9: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Since 7 April 2017*
Price relative to S&P Lev Loan	(6.9)	(9.4)	(7.1)	(4.8)	15.2
NAV relative to S&P Lev Loan	0.9	0.7	7.9	6.9	14.9
Price relative to Credit Suisse HY Index	(7.9)	(13.9)	(15.4)	(7.8)	19.1
NAV relative to Credit Suisse HY Index	(0.1)	(3.8)	(0.4)	3.9	18.9

Source: Refinitiv, Edison Investment Research. Note: *Annualised.

Exhibit 10: Share price premium/discount to NAV (including income) since launch 7 April 2017 (%)



Source: Refintiv

Peer comparison

Exhibit 11 compares EJFI's NAV total performance in sterling terms with nine other peer funds. It has significantly outperformed its peers over the last six and 12 months (11.4% vs 7.1% weighted average). EJFI's dividend yield is 6.3% based on the latest-declared quarterly dividend and stated dividend policy. This is at the lower end of a wide range, but the comparison is qualified by different strategies, risks and dividend policies. Its ongoing charges are above average at 2.2%, reflecting that EJFI is still a relatively young fund that would benefit from further scale. We note that 100% of recurring ongoing charges during the first six months of 2019 were absorbed by EJF and 90% will be until 1 January 2020 at the earliest, and then at least 75% of the same costs until the fund's NAV reaches £300m. The 2.2% figure includes all charges but not the incentive plan (paid out in shares), as well as the EJF rebate. With the latter, the annualised charge for the six months to June 2019 would be 0.9%.

Exhibit 11: Selected AIC sector peer group in sterling terms at 30 September 2019

Group/Investment	Market cap £m	NAV TR 6mo (%)	NAV TR 1yr (%)	Premium (discount) (%)	Ongoing charge (%)	Perf. fee	Net gearing (%)	Dividend yield (%)
EJF Investments	109.1	9.8	11.4	(10.1)	2.2*	Yes	105	6.3
Blackstone/GSO Loan Financing	280.3	7.2	8.1	(12.5)	0.4	No	100	12.7
Carador Income Fund USD Ord	25.2	(2.5)	(8.2)	0.2	1.8	Yes	100	10.8
Chenavari Capital Solutions	34.4	(2.4)	(1.5)	(11.9)	1.7	Yes	100	3.0
Chenavari Toro Income Fund Limited	226.4	15.5	18.6	(18.0)	1.4	Yes	100	9.7
Fair Oaks Income 2017 Ord	275.6	7.9	5.2	(4.5)	0.3	No	100	14.9
Marble Point Loan Financing Ord	131.9	3.5	(2.4)	(1.5)	1.5	No	100	10.1
TwentyFour Income Ord	547.6	1.3	4.3	(3.1)	1.0	No	100	5.9
VPC Specialty Lending Investments Ord	255.1	8.7	11.8	(12.9)	1.9	Yes	100	10.1
Volta Finance Ord	218.1	5.7	4.5	(13.5)	1.9	Yes	116	9.1
Simple average	**210.4**	**5.5**	**5.2**	**(8.8)**	**1.4**		**102**	**9.3**
Weighted average		**6.3**	**7.1**	**(8.8)**	**1.2**		**102**	**9.5**
EJFI rank	8	4	3	5	1		2	8
Median	222.3	6.4	4.9	(11.0)	1.59		100	9.9

Source: Morningstar, AIC, Edison Investment Research. Note: EJFI yield based on the latest dividend declaration. *Before EJF rebate.

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