

EJF Investments

Seeking gains from regulatory changes

Initiation of coverage

Investment companies

EJF Investments (EJFI), launched in April 2017, seeks to earn attractive risk-adjusted returns by investing in opportunities created by regulatory and structural changes affecting the financial services industry. While it can invest in a broad range of financial products in the US and Europe, it is mostly focused on US securitisation risk retention investments and specialist lending. The manager continues to see many opportunities in these core target areas and may expand into European assets in EU risk retention, specialist lending and capital solutions.

Strong start

EJFI has had a strong start since its April 2017 launch, with its NAV total return of more than 19% annualised (end December 2018) helped by capital gains from the sale of some legacy securitisations. Management targets a total return of 8–10% pa inclusive of a 10.7p annual dividend paid quarterly.

Strategy: CDO equity and niche lending

The biggest focus is on collateralised debt obligation (CDO) equity tranches collateralised by US community and regional banks and insurance companies' subordinated debt. There has been understandable concern in recent months regarding high-yield/leveraged loan asset prices in the face of growing leverage, rising interest rates and weaker loan covenants. However, EJFI targets the financial sector (usually investment grade), where systemic changes driven by regulatory reforms and economic growth have resulted in more robust balance sheets and healthy profitability. The increase in interest rates actually helps revenue, while regulatory relief measures and lower taxes further boost the outlook. EJFI acts as a partner to EJF-sponsored securitisations by buying portions of equity tranches in CDO securitisations that offer an interesting risk-return profile – the expected IRRs of EJFI's CDO equity investments range from 10–23%, with leverage (1.6–6.7x) below the 9–10x often seen in the leveraged loan-backed CLO market. Elsewhere, regulation is encouraging some banks to exit or diminish their presence in some niche areas, opening opportunities for specialist investors such as EJFI. Other positions include law firm lending and a bridge loan to an insurance company.

Benefiting from EJF

EJFI's relationship with EJF Capital (EJF) allows it to make use of EJF's expertise (especially as it relates to underwriting and managing securitisations), credit analyses, relationships and support. EJFI has privileged access to EJF securitisations, with rights of first refusal on the risk-retention requirement, and also has a 49% stake in the collateral manager allowing for a yield pick-up from the capitalisation of the associated anticipated fee stream. To underpin its commitment to the fund, EJF is absorbing recurring operating costs until at least 1 July 2019.

Valuation: Trades close to NAV

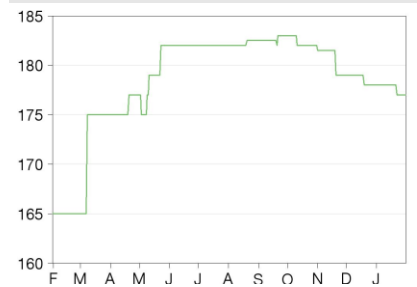
Since its launch EJFI has traded fairly close to its NAV. It is now at a 0.8% discount, having come from a 4% premium in the mid-year.

31 January 2019

Price 177p
Market cap £113.6m

NAV per share (31 December 2018) 178p
Shares in issue 64.2m
Free float 56.3% estimated
Code EJFI
Primary exchange LSE – Specialist Fund Segment

Share price



%	1m	3m	12m
Abs	(0.6)	(2.8)	7.3
Rel (local)	(4.3)	(1.8)	17.1
52-week high/low		183p	165p

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 event

Annual report March 2019

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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

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

- 25 January 2019: 2.675p Q418 dividend declared, up from 2.5p previously
- 10–24 December 2018: 3.618m shares sold at 181.8p, raising £6.6m for fund.
- 5 November 2018: 9m shares issued at 182p per share and repurchased to be held in treasury available to be sold to meet ongoing market demand.
- 28 August 2018: H118 results – NAV total return +16.3% vs S&P Leverage +2.1% and Credit Suisse West. Europe HY Index -2.3%, all in £.

Forthcoming

EGM	14 Feb 2019
AGM	June 2019 est.
Interim report	August 2019 est.
Year end	31 December
Dividend paid	May, Aug, Nov, Mar
Launch date	7 April 2017
Continuation vote	Yes

Capital structure

Ongoing charges	2.4% (H118), before EJF rebate
Gross debt % NAV	18.5%
Annual mgmt fee	1%
Performance fee	10% over 8% IRR hurdle rate and high watermark
Company type	Closed-ended
Loan facilities	US\$ credit facility

Fund details

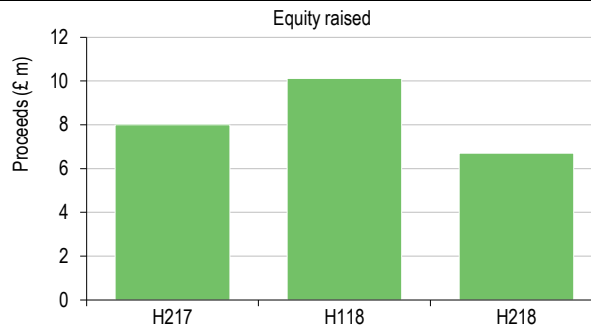
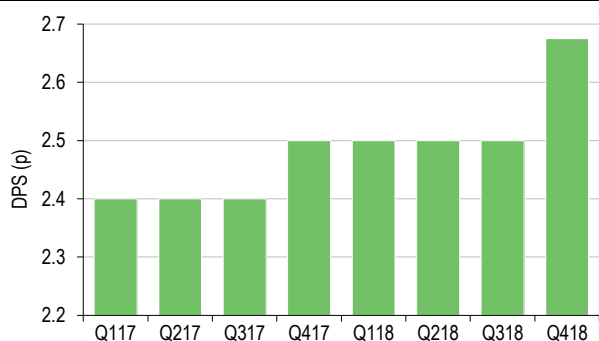
Group	EJF Investments
Manager	EJFI Manager
Address	47 Esplanade St Helier, Jersey JE1 0BD
Phone	+44 20 7901 8328
Website	www.ejfi.com

Dividend policy and history

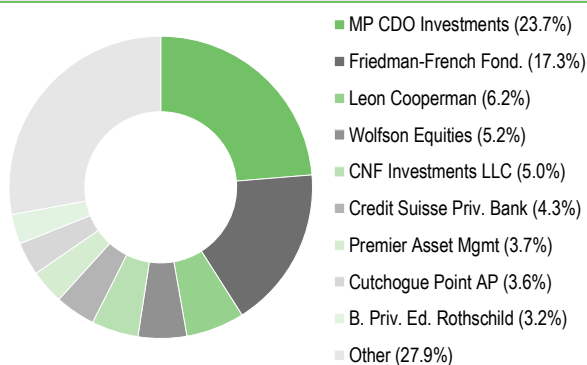
EJFI pays dividends quarterly; this was increased from 2.5p to 2.675p in Q418. EJFI now targets a dividend of 10.7p annually, paid quarterly.

Share buyback policy and equity funding history

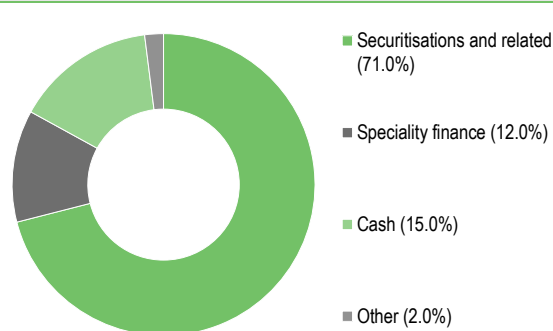
Management has authorisation to buy up to 14.99% of ordinary shares. The company will seek approval at the EGM on 14 February to be able issue shares up to 20% of capital without needs of pre-emptive rights and prospectus



Shareholder base (as at 31 December 2018)



Portfolio exposure by asset class (as at 31 December 2018)



Top holdings

Holding	Asset category	Description	% of portfolio value	
			31 Dec 2018	31 Dec 2017
EJF sponsored CDO equity	Securitisations	Collateralised by US community and regional bank/insurance	52.6	17.9
TruPS CDO equity	Securitisations	Not EJF sponsored, bought in July 2018	8.3	31.1
EJF CDO Manager	Collateral mgmt	49% stake, co-owned w/ EJF. Manages collateral in EJF securities	7.0	7.7
Bridge loan	Specialist lending	Bridge loan affiliate of US listed insurance company, 2020 maturity	6.7	4.9
Armadillo	Specialist lending	Lending to US law firms engaged in mass tort litigation	4.7	17.4
US bank subordinated debt	Subordinated debt	Eligible for future securitisation	4.3	0.0
Other assets	N/A	N/A	1.8	6.3
Cash	N/A	Restricted and unrestricted cash	14.7	7.2

Source: Company data

Fund profile: Regulation providing opportunities

EJFI is a Jersey-domiciled, closed-end investment company listed on the Specialist Fund Segment in the LSE. Its manager, EJFI Manager, is wholly owned by EJF Capital (EJF), a US-based alternative asset manager with a presence in London. The fund started to trade 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, 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 year.

EJFI's biggest focus is on the equity tranches of CDO securitisations backed by trust preferred shares (TruPS) and other debt securities of US community and regional banks and insurance companies. Management believes the risk-return profile of these securities is appealing and that prospects are helped by favourable regulatory and economic tailwinds.

Regulatory relief legislation (see pages 5/6) has helped the US smaller banks. Legislation has simplified capital rules for these banks and made compliance and reporting less onerous. Thresholds have been widened to allow more banks to benefit from favourable legislation such as the Small Bank Holding Company Policy, which makes capital formation easier and helps encourage merger and acquisitions activity between these banks.

As the benefits of this regulatory easing flows through to smaller banks, EJFI is gaining exposure by buying CDO equity tranches collateralised by their debt. This allows it leveraged exposure. Meanwhile, 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. European authorities have their own securitisation rules in which retention requirements may differ from US legislation. EJF has marketed some of its CDOs in Europe and these are therefore European regulation compliant. 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 provides EJFI with privileged access to these securities through rights of first refusal on the 5% retention plus 49% of the collateral manager for a yield pick-up from the additional management fees. So far, all five CDO equity tranches have been EJF sponsored, but EJFI is not restricted from investing in other sponsored securitisations, or even from being a sponsor itself. The expected IRRs of these five CDO equity tranches are quite attractive, ranging from 10% to 23%. The majority of the underlying collateral in the securitisations are floating rate, so 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 71% of EJFI's portfolio value as of end-December 2018. The weight is expected to increase as management continues to be bullish on this asset class.

Not all CDOs are created equal

There has been growing regulator and investor concern in recent months regarding the high-yield and leveraged loan markets. These stem from asset price worries in the face of growing leverage in issues, rising interest rates and weaker loan covenant quality. However, EJFI's selective approach gives it a significantly differentiated exposure and characteristics that should mitigate the risk inherent in equity tranches of CDOs:

1. **Choice of sector important.** The US financial sector balance sheets are now more robust as a result of structural changes following the financial crisis in 2008/09 and continued economic growth. The EJFI securitisations' collateral is mostly from investment-grade institutions.

Furthermore, and as mentioned, the outlook for the smaller and medium-sized US banks is specifically boosted by the regulatory relief legislation.

2. **Rising interest rates help financials.** Higher interest rates generally mean heavier debt payments for borrowers and greater default risk. However, in the case of banks there is an important boost to revenue when this generates a wider interest margin. Given the current economic outlook, this is likely to more than offset the negative impact on bank asset quality from borrowers affected by higher interest rates. In the case of insurance companies, higher interest rates are typically even more consistently positive. Furthermore, the collateral in the EJFI invested CDOs is made up mostly of floating rate instruments, which tend to perform better in a rising interest environment than fixed rate.
3. **Relatively lower gearing.** EJFI's securitisation investments have gearing levels (ranging from 1.6–6.7x) that are lower than many in the market, where some securitisations gearings are reaching 9–10x. Despite the relatively lower gearing, the expected IRRs are still attractive, as previously noted.
4. **Greater transparency on the EJV-sponsored securitisations.** In most securitisations, the CLO manager is able to reinvest the inflows into new loans for a period of two to five years. In contrast, EJV securitisations are static with no reinvestment. This gives investors more clarity at the point of investment on the expected return and risk exposure of the investments.

Niche lending opportunities

EJFI is also optimistic on the non-bank lending niche opportunities that arise as banks exit or diminish their presence in selected areas as they focus their capital on core products. This speciality finance segment in EJFI essentially consists of a bridge loan to an affiliate of a listed insurance company and high yielding collateralised loans to law firms (Armadillo). The company anticipates that any expansion into Europe will be focused in specialist lending, asset capital solutions and/or securitisation risk retention investments.

Aligning the interests

Considerable effort has been made to create alignment of interests between EJFI, the EJFI Manager (its management) and EJV. These include: c 23% of EJFI shares is owned by principals and affiliates of the manager; EJV retains a minimum 15% stake in the EJV Partnership (the EJFI vehicle that invests in the risk-retention tranches); to date, 100% of equity issued by EJV-sponsored CDOs are owned by EJV-managed entities; the CDO Manager is co-owned by EJFI and EJV; EJV covered all of EJFI's launch costs and the recurring operating expenses until at least 1 July 2019 (excluding management and incentive fees); and the a strategic link between CDO origination at the EJV level and the co-investment in the risk-retention tranches.

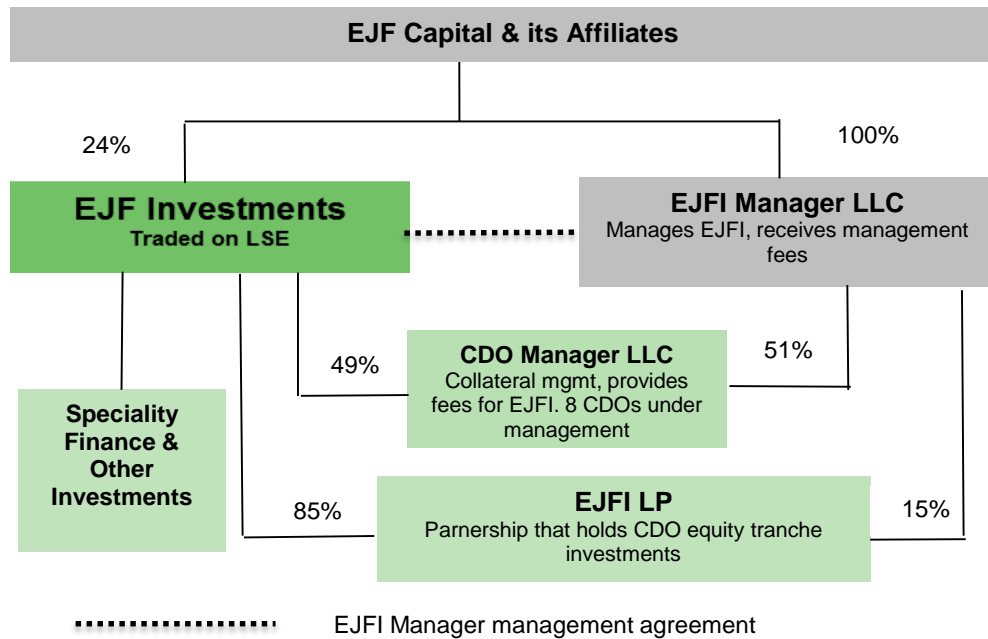
LT leverage capped at 30%

There are 64.175m shares in issue with market cap of £113.6m, 0.8% below the end-December NAV. The company has been trading close to NAV since launch. Reflecting an ambition to expand to meet investor demand and seize the investment opportunity, in 2017 the company raised £29m of new capital (including £15m in zero dividend preference shares) and in 2018 it raised £17.0m in new equity. It also raised £15m in December 2017 debt structured as zero dividend preference (ZDP) shares, which are payable in December 2022 at an annual cost of 5.75%. The company has also entered into a £5.2m repurchase agreement in respect of a single TruPS CDO security. The total gross gearing to NAV is 18.5% (essentially the ZDP shares and this repo agreement) as of 31 December 2018. 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. The difference is that EJV has a short-term loan facility that can be accessed if there are short term liquidity needs. So far this facility has not been used.

Structure

Exhibit 2 shows EJFI's structure, including its relationship with EJV. There are two entities worth highlighting: the EJV Partnership and the CDO Manager. The EJV Partnership is the vehicle jointly owned by EJFI (85%) and EJV (15%) for the investment in the risk-retention investments. The CDO Manager (EJFI owns 49% stake, and EJV 51% through its 100% stake in the EJFI Manager) manages the collateral of the CDOs. This allows EJFI to pick up an initial yield and subsequent cash flow from management fees associated with the EJV sourced CDOs. The fees are typically 10–20bp per annum and some contracts may earn an incentive fee if hurdles are met.

Exhibit 2: EJFI structure



Source: EJFI

Fund manager: EJFI Manager

The EJFI Manager is 100% owned by EJV. At the end of November 2018, on a discretionary basis EJV and its affiliates managed about US\$7.8bn of debt and equity securities and US\$2.8bn of securitisation assets. The relationship and support from EJV is a key advantage for EJFI. EJV provides services in three broad areas: portfolio management functions, research and investment analysis; contacts and relationships ranging from industry, asset management, broker/dealers etc; and providing EJFI with a pipeline of investments, including the risk-retention investments.

The EJFI management team is led by Neal Wilson as CEO with over 25 years of experience. The chairman and co-CIO is Emanuel Friedman (over 40 years of experience). Lindsay Sparacino (over 15 years) is co-CIO and Peter Stage (over 20 years) is the CFO and Hammad Khan (over 15 years) completes the investment committee team.

The team has invested in the US and European financial sectors since 1992 and 2011, respectively. This includes experience with TruPS, CDOs, ABS and various debt and equity investments of US community banks, as well as opportunistic investments in debt and equity. Since 2007, EJV has been launching funds focusing on the financial services financial instruments including equity, debt and hybrids instruments such as TruPS.

Management has the experience, skills, relationship and infrastructure to analyse, invest and monitor this niche area. The permanent capital structure of EJFI allows for a longer-term investment horizon. This can confer an advantage over funds more constrained by liquidity or capital returns requirements. The long-term horizon is also helpful to permit collateral management activities in the CDO Manager.

Regulatory opportunity

The regulatory opportunity shaping EJJ's investment strategies has its origins in the financial crisis of 2008/2009. Subsequent regulation sought to reduce risk in the banking sector, force banks to carry more capital and operate under tighter supervision. The overarching aim was to strengthen the banking system and confidence in it. In the US, much of the regulation was centred on the Dodd-Frank Act, which became effective in 2010. However, there has been some rollback in the form of regulatory relief legislation particularly aimed at helping the smaller community banks. At the same time, regulation has also resulted in many banks focusing on their core markets while exiting or deemphasising others. This has opened opportunities for EJFI.

- **Asymmetric capital regulation.** Since the Dodd-Frank Act was introduced, the smaller US banks have felt the impact strongly, with their market share in assets dropping from 40% in 2009 to 20% in 2017. The Small Bank Holding Company Policy Statement already provided relief. However, the Economic Growth, Regulatory Relief, and Consumer Protection Act passed in May 2018 aims to reduce the burden of the Dodd-Frank Act and help these smaller banks lend more and promote growth. In effect, there has been a rollback of some of the onerous regulation regarding capital and compliance requirements. The regulatory asymmetry exists because the reliefs are not equally extended to the larger banks. Some of the measures of the new Regulatory Relief Act introduced in May 2018 include:
 - The systemically important financial institution (SIFI) threshold moved from US\$50bn in assets to US\$100bn and then US\$250bn. SIFI banks have the greatest capital requirements and strictest regulatory oversight.
 - Capital simplification for banks smaller than US\$10bn. They will be able to avoid some of more complex Basel III capital requirements that larger banks will have to continue to follow.
 - Less onerous regulatory filing reports, easier compliance rules.
 - Increasing the small bank holding company (Small BHC) policy threshold from US\$1bn to US\$3bn in assets. The Small BHC policy is designed to ease mergers and acquisition activity between banks and to facilitate capital formation. One of the benefits of increased M&A activity is that these banks are more likely to prepay TruPS.
 - Lighter regulation in areas such as mortgages, escrow exemptions, appraisal easing and waiting periods for lending.
- **Securitisation risk-retention rules.** As part of the Dodd-Frank Act, securitisation sponsors have to retain at least 5% of the defined credit risk on their balance sheet. These rules were effective for all US securitisations from 24 December 2016; since then there have been some carve-outs but EJJ-sponsored securitisations still require a risk retention partner. The aim is to more strongly align sponsors' interests with those of investors. This encourages some securitisers to seek partners to meet this requirement. The sponsors either can hold this interest directly or through a majority owned affiliate, while some alternative risk-retention methods permit retention of risk by other third parties. EJFI is a partner to EJJ Capital, who is the originator, in this respect. As noted earlier, EJFI has the first right of refusal on all EJJ

Securitisations of at least 5%. The investment vehicle is the EJV partnership between EJV and EJFI (85% held by EJFI and 15% by EJV).

- **Regulation has meant underserved niches have increased.** Regulation and higher capital requirements are encouraging the larger banks to focus on their core products and this generates opportunities for non-bank lenders. There are various bank disintermediation trends, which range from peer-to-peer lending to direct lending to these underserved niches. EJFI actively invests in such opportunities, for example, its position in law firm lending and the bridge loan to the insurance company. As is the case with the other regulatory opportunities, EJFI leverages EJV Capital's relationships and sector knowledge.
- Augmenting the impact of regulatory changes, recent **corporate income tax cuts** have helped lending conditions and asset quality in the financial sector.
- The manager continues to see many opportunities in these core target areas and **may expand into European assets** in related areas such as specialist lending, capital solutions and risk retention”.

CDO equity and risk retention

EJFI's largest asset class is its five EJV-sponsored CDO equity tranches, all backed by US community and regional banks and insurance company TruPS and subordinated debt. This is an asset class on which management has a positive view and in which it has been increasing EJFI's exposure during 2018. Because of its weight in the portfolio, we will go into some detail on this investment area before discussing EJFI's other positions.

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 go into the equity tranche. EJFI buys into the equity tranche of these CDO securitisations, a minimum of 5% of the deal total market value, which represents the risk retention requirement.

Although CDOs may be backed by a range of debt classes, those that EJFI invests in are subordinated debt mostly in the form of TruPS (hybrid equity/debt instruments). These securities were very popular with US banks because they were treated as debt (so interest payments were tax deductible), but at the same time counted as tier 1 capital. This means essentially they were a tax-efficient and relatively lower-cost form of bank capital.

From a bank point of view, this was an efficient way to boost capital. From an investor point of view, these instruments offer a higher rate of return. The higher risk comes in the form of being subordinated to other debt and from loss absorption features such as the ability to defer interest payments for five years.

EJFI management estimates that about US\$119bn in TruPS were issued by US banks and insurance companies between 2000 and 2007 and half of this was securitised into CDOs. The pooling of TruPS from various financial companies into CDO securitisations, allowed smaller banks and insurance companies to have better access to capital markets.

TruPS tailwinds

After the financial crisis of 2008/2009, the allure of hybrid instruments from the banks' point of view diminished. Investors in bank equity were demanding more straight equity capital instead of hybrids and the regulators stopped considering TruPS as core tier 1 in larger banks (as part of the Volker Rule). At the same time, some banks suspended interest payments on these securities for a few years to rebuild their capital position after the crisis. Furthermore, many buyers of these TruPS

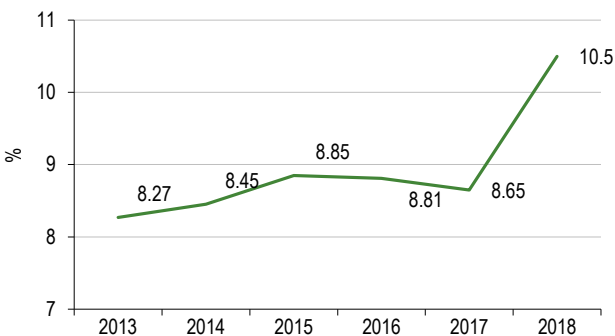
were the community banks themselves. This created the risk of a feedback loop. The Dodd-Frank Act incentivised these banks to start offloading their investments in the TruPS; this all contributed to significant declines in TruPS prices.

This provided an opportunity for other investors, such as hedge funds. TruPS yields are relatively attractive and the outlook for the issuing banks has improved as banks' balance sheets have become healthier and the banking system is more structurally sound. The tailwinds from tax cuts and rising interest rates are helping bank profitability (by widening interest margins, which were compressed when interest rates dropped during the recession) and, in the case of interest rates, the TruPS prices as well given they are floating rate.

Furthermore, the recent regulatory changes not only bolster the sector by promoting merger and acquisition activity, they also make it more likely that banks will pre-pay these relatively high yield debt instruments.

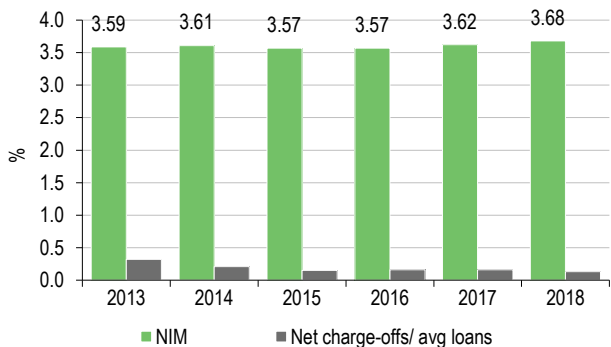
As Exhibit 3 shows, US community banks' profitability (shown here as RoE) has risen appreciably this year to 10.5% after being 8–9% in recent years. Exhibits 4 and 5 show the drivers. A key factor has been wider interest rate margins that, along with asset growth, allowed for a 9% increase in net interest margin (NIM) in Q318 y-o-y. Operating expenses seem under control at 6% y-o-y, while the loan-loss ratio keeps coming down and lower taxes drove Q3 earnings growth to 22% y-o-y (an increase of US\$1.2bn; Exhibit 5 illustrates the contribution of the various income and cost lines to this figure).

Exhibit 3: US community banks RoE (%)



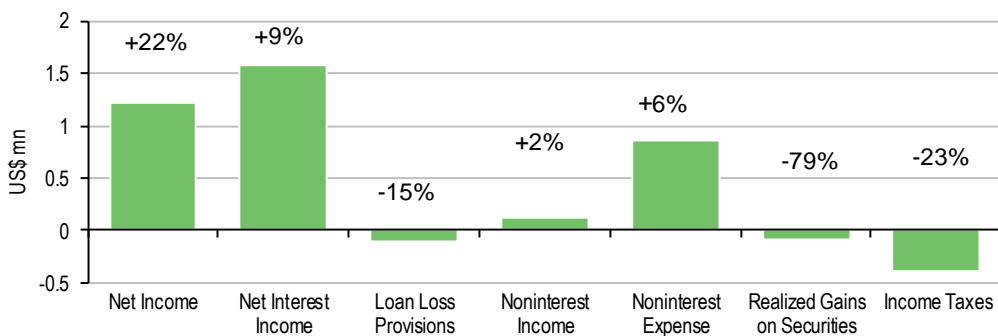
Source: FDIC. Note: 2018 figure is annualised.

Exhibit 4: US community banks NIM, net charge offs (%)



Source: FDIC. Note: 2018 figures are annualised.

Exhibit 5: US community banks y-o-y income drivers



Source: FDIC. Note: Percentage numbers are y-o-y.

The US insurance market is also benefitting from rising interest rates and economic tailwinds. Property and casualty (P&C) insurance companies usually make their money from the investment income on their reserves rather than on the actual underwriting margin. Investment yields have bottomed at around 3% and are now starting to move up as rates increase. The US 10-year bond yield troughed at 1.37% in July 2016. It is now at 2.7%, after being over 3% yield in late 2018. The industry is now well capitalised; this is likely to encourage M&A activity and benefit TruPS prices.

EJFI is particularly well positioned to take advantage of this opportunity because: EJF has experience in TruPS underwriting, other bond issued debt, credit analysis and management; EJFI has the ability to leverage off the experience, contacts and support of EJF; and EJFI is able to generate an initial yield and subsequent cash flow by management of the collateral through its 49% interest in the CDO Manager. Management believes many opportunities remain in this asset class.

The five risk-retention investments

EJFI has bought five EJF risk-retention investments: three in 2017 and two in 2018. We note that the TFINS 2018-2 CDO was issued in December 2018, a month when no US high-yield bonds were issued. All are the equity tranche of the respective CDOs. The expected IRR of these investments ranges from 10% to 23%. The underlying collateral is mostly floating rate, with average yields ranging from 270bp to 400bp above Libor. The securities are all callable two years after closing date, with mandatory auction dates in eight years from closing date. The collateral is mostly TruPS and the mix between bank and insurance debt varies between CDO. It ranges from almost fully bank debt to 100% insurance; in total there is more insurance (about 60% of total) than bank debt. The CDOs are geared, ranging from 1.6x to 6.7x, to achieve a higher yield. EJFI collects collateral management fees (10–20bp) on all five CDOs and Exhibit 6 shows the yield pick-up from these fees.

Exhibit 6: The five risk-retention CDO investments					
	TFINS 2017-1	TFINS 2017-2	TPINS 2016 Restructuring	TFINS 2018-1	TFINS 2018-2
Deal date	Mar 17	Oct 17	Dec 17	May 18	Dec 18
Collateral overview (on closing date)					
Banks/insurance split of collateral	72%-28%	51%-49%	0%-100%	93%-7%	79%-21%
Collateral principal balance (US\$m)	360	353	327.2	537.8	351
TruPS/subordinated debt	98%	97%	90%	99%	94%
Floating rate	83%	90%	100%	93%	99%
WA collateral yield	Libor + 3.1%	Libor + 3.1%	Libor + 4.0%	Libor + 2.7%	Libor + 3.0%
Implied rating	Baa3/Ba1	Ba1	Ba2	Baa3	Baa3
CDO Structure (on closing date)					
Weighted average cost of debt	Libor + 2.4%	Libor + 2.3%	Libor + 2.0%	Libor + 1.7%	Libor + 1.9%
Leverage ratio	4.0x	4.3x	1.6x	6.7x	5.7x
Non call date/auction call date (mm/yy)	Apr-19, Apr-25	Sep-19, Sep-25	Apr-19, Apr-24	Mar-20, Mar-26	Dec-20, Dec-26
Estimated return profile					
EJFI - CDO equity amount (US\$m)	20.1	14.5	13.4	22.7	17.5
Current Yield	10.50%	12.30%	9.50%	11.30%	9.00%
Current Yield w/ CDO mgmt fee	11.30%	13.10%	10.90%	12.30%	10.50%
Management fee	10bp	10bp	20bp	20bp	20bp
IRR range (YTM - YTC)	15% to 23%	13% to 16%	10% to 12%	11% to 13%	10%-11%
Source: EJFI data					

Sensitivities

The key risks and sensitivities we highlight are:

- Regulatory changes could affect both 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 where an accurate determination of prices is not always easily achievable.
- Despite corporate governance measures and efforts to align interests between EJJ, EJFI and EJFI Manager, there is risk that conflict of interests may affect investment decisions; deal allocations for example.
- Banks and insurers tend to be cyclically sensitive and therefore quite exposed to changes in the economic growth outlook.
- Negative interest rate risks could have an impact on security valuation and investment opportunities.

Asset allocation

Investment process

Most of the investment ideas for EJFI's portfolio are provided by EJJ's portfolio managers, research analysts and traders. Investment opportunities are typically initially reviewed by the relevant EJJ research analysts. They are then previewed by the investment committee and followed by a formal investment memorandum containing the relevant information. Due diligence is undertaken by the research team. We note that EJJ has more than 30 employees performing investment work, including research. The investment committee then makes its decision, with input from its traders as needed. The investment committee comprises three voting members (Emanuel Friedman, Neal Wilson and Lindsay Sparacino) and two non-voting (Peter Stage and Hammad Khan).

All securitisation risk-retention investments require a unanimous board decision. Furthermore, Neal Wilson cannot vote on EJJ-sponsored securitisations; only the independent directors may do so. The valuations are carried out by independent third parties.

There are three relevant parties in the asset allocation and decision making process: EJFI, EJFI Manager and EJJ, which has other investment entities and clients. Decisions on how to allocate investments are based on the risk/return profile, investment guidelines and objectives and liquidity objectives of the various funds and clients.

Current portfolio positioning

At the end of December 2018, securitisation and related assets accounted for 71% of EJJ's NAV. About two-thirds of this was in the EJJ-sponsored risk-retention equity tranches. Within this bucket, EJFI has a portfolio of TruPS CDO securitisations that accounts for 10% of NAV. This used to be higher (31.1% of NAV at end of 2017) but it has sold down the legacy CDOs with capital gains to reinvest in risk-retention investments. Finally, the EJJ CDO Manager accounts for 8.4% of NAV.

Law firm lending has now dropped to 5.7% (31 December 2018) of NAV from 17.4% at the end of 2017. The bridge loan to the insurance company affiliate increased its weight to 8.0% because some of the interest due is being capitalised (it is a payment in kind loan).

There is some bank subordinated debt (5.2%, 31 December 2018), which is eligible for securitisation and an unrestricted cash position of 11.7% of NAV.

Rebalancing towards cash-flow investments

Having realised some capital gains with the sale of some of the legacy investments, management's strategy is now to rebalance the portfolio towards current cash-flow investments. They are looking

for more stable, predictable cash flows that support the quarterly dividend payments. The risk-retention investments remain the highest exposure, but EJV is also interested in other quarterly paying CDOs. The risk-retention investments are centred on EJV-sponsored securitisations due to synergies and privileged access. Investments in the other CDOs, such as the real estate (REIT) CDOs will be made opportunistically according to market conditions. As described above, EJV will continue to take advantage of EJV resources, including trades, for feedback and investment ideas.

Speciality finance

The law firm lending portfolio (Armadillo) position is now only 5.7% of total NAV following a \$2.8m (2.5% of NAV) write-down in December 2018. This write-down related to a decrease in the valuation of collateral relating to two of the loans in the portfolio. The remainder of the portfolio continues to pay down, generating some income for the company. This lending is to the law firms themselves. EJV expects the Armadillo weighting in the portfolio to fall further.

The insurer bridge loan had a 14% interest at inception with a maturity of January 2020. It is being used for short-term liquidity by the insurance affiliate. The borrower typically pays some interest on it; the remainder accrues as payment in kind on the principal balance. This loan accounts for 8% of the NAV and is now EJV's biggest speciality finance asset.

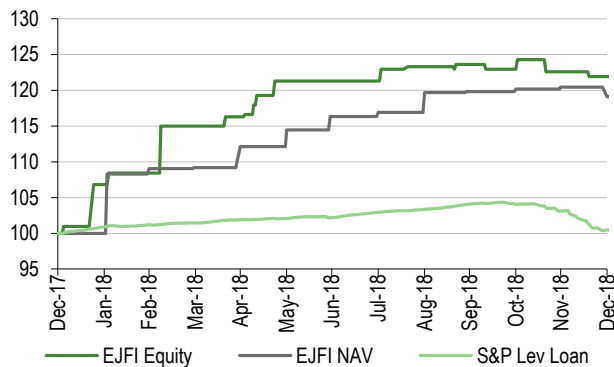
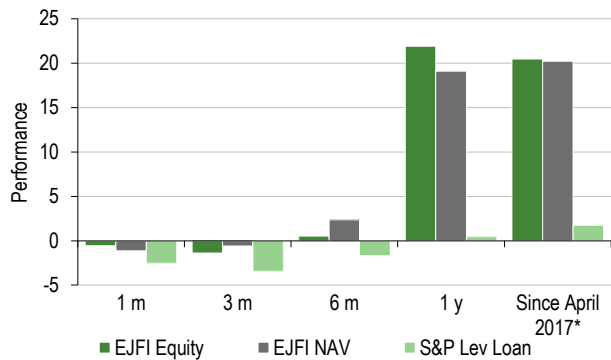
FX hedging

The US dollar assets are hedged into sterling using forward contracts. The hedge is assessed weekly and rebalanced to ensure all USD fair value exposure and any significant transactions are taken into account. On occasion, income streams or a gain may be hedged. However, as a rule income is not hedged.

Strong outperformance

Looking at total NAV return returns to end of December 2018, EJV has delivered 19.1% over the last 12 months. The annualised total return performance since the fund started trading on 7 April 2017 is 19.9%. As of 31 December 2018, this outperformed the S&P Leveraged Loans Index by 18.5% and Credit Suisse High Yield Index by 41.9% over 12 months. The gains have been driven not only by the performance of the retained risk investments and specialised lending, but also by gains on the sale of legacy real estate TruPS investments. While the performance in the last three months has been trading closer to the S&P Leveraged Loan Index, it continues to outperform the Credit Suisse High Yield by 16.6% and 17.5% (price and NAV, respectively).

Management notes that its core risk-retention investment portfolio and the underlying collateral continue to perform well. There has been good prepayment activity during the year, allowing for senior note tranche redemptions. This improves the value of the equity tranches held by EJV, by reducing gearing and boosting expected IRR by potentially making early calls before maturity more likely.

Exhibit 7: Investment company performance to 31 December 2018
Price, NAV and index, total return performance, one-year rebased

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


Source: Thomson Datastream, Edison Investment Research. Note: *Annualised.

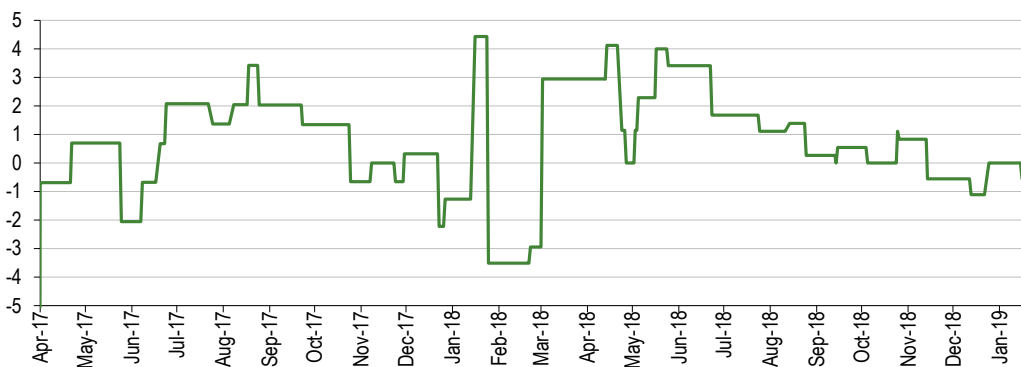
Exhibit 8: Share price and NAV total return performance, relative to indices (%)

	1 month	3 months	6 months	1 year	Since 7 April 2017*
Price relative to S&P Lev Loan	2.0	2.1	2.2	21.3	18.4
NAV relative to S&P Lev Loan	1.5	2.9	4.1	18.5	17.8
Price relative to Credit Suisse HY Index	4.1	16.6	17.0	45.3	25.0
NAV relative to Credit Suisse HY Index	3.5	17.5	19.2	41.9	24.3

Source: Thomson Datastream, Edison Investment Research. Note: *Annualised.

Trades close to par

EJFI's share price has been hovering relatively close to fair value since the fund started trading in 2017, usually at a small premium. However, it is currently trading at a 0.6% discount to NAV (31 December 2018), down from a peak 4% premium in mid-2018.

Exhibit 9: Share price premium/discount NAV (including income) since launch 7 April 2017 (%)


Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

EJFI's capital structure includes 64.23m ordinary shares together with 15m ZDP shares. These were issued in December 2017, with a maturity date of 1 December 2022 and a final capital entitlement of 132.35p for a gross redemption annual yield of 5.75%. Management has the authorisation to repurchase up to 14.99% of its own ordinary shares, to be renewed annually. Share buybacks are discretionary. In November 2018, the fund sold nine million shares and subsequently

repurchased them and put them into treasury. It then reissued £6.7m (3.6m shares) of these shares in December 2018.

Long-term gearing is limited to 30% of NAV and the investment company cannot use its risk-retention investments for gearing, nor as collateral for any of its borrowing. It may borrow for share buybacks and short-term liquidity reasons. The company's only current significant fixed obligations are its ZDP shares and its repurchase agreement. The ZDP shares amount to £15.95m, and the repurchase agreement adds £5.2m, giving total gearing of £21.15m, at the end of 2018. This leaves EJFI with gross gearing to NAV of 18.5%, below the 30% long-term gearing threshold. The net debt figure is 6.8% of NAV, factoring in the £13.4m in unrestricted cash.

EJFI issued 9m shares on 5 November 2018 at 182p per share. These were then repurchased to be held in treasury and available to be sold to meet ongoing market demand through Numis. EJFI raised £10.3m during the first half of 2018 in two offerings. In December 2018 3.4m shares were issued at a price of 181.8p, raising a further £6.2m.

EJFI Manager charges a management fee of 1% of NAV per annum. There is also a performance fee of 10% for NAV total return above an 8% hurdle rate; this is paid in cash, which is used to purchase shares.

The ongoing charges (ex-incentives and EJF rebate) were an annualised 2.4% of NAV during 2018. As a sign of commitment and a desire to see the fund grow, EJF is absorbing recurring operating costs until at least 1 July 2019. Portfolio performance and potentially faster issuance could reduce the expenses ratio. It also changed its placement agent from Liberum to Numis, while appointing a new communications advisory company.

Peer comparison

Exhibit 10 compares EJFI NAV total performance in sterling terms with eight other peer funds. EJFI outperformed all of these peers by quite a margin over the last 12 months at 19.1% (weighted average for the peers is 6.3%). Over the last six months, EJFI's total return was 1.8%, which is higher than the 1.5% average for the peers. EJFI's dividend yield is 6.0% based on the latest declared quarterly dividend and stated dividend policy. This is at the low end of a wide range, but the comparison is qualified by different strategies and dividend policies. Furthermore, recent significant share price declines in some funds may indicate there is some concern among investors regarding the level of future dividends. Its ongoing charges are above average at 2.4%, reflecting the fact that EJF is still a relatively young fund that would benefit from further scale. We note that the recurring ongoing charges (just over 50% of total charges during first six months of 2018) are being absorbed by EJF and not shareholders until at least 1 July 2019. The 2.4% figure includes all charges.

Exhibit 10: Selected AIC sector peer group in sterling terms at 22 January 2019

Group/Investment	Mkt cap £m	NAV TR 6mo	NAV TR 1yr	Premium (discount)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
EJF Investments	113.6	1.8	19.1	(0.5)	2.4	Yes	115	6.0*
Blackstone/GSO Loan Financing	267.1	9.5	12.5	(15.5)	0.5	No	115	13.2
Chenavari Capital Solutions	40.9	0.5	2.1	(12.8)	1.7	Yes	83	6.4
Fair Oaks Income 2017 Ord	277.7	3.3	13.5	(4.8)	0.7	No	98	13.9
Marble Point Loan Financing Ord	132.3	(5.9)		0.0		No	100	8.4
TwentyFour Income Ord	463.6	2.5	3.8	0.3	0.9	No	99	6.5
Volta Finance Ord	215.4	(1.3)	2.7	(12.5)	1.9	Yes	113	9.2
VPC Specialty Lending Investments Ord	274.9	0.6	3.8	(15.1)	3.8	Yes	96	10.4
Simple average	211.1	0.2	5.4	(7.2)	1.8		100	9.4
Weighted average		1.5	6.3	(7.4)	1.6		102	9.8
EJFI Rank	8	4	1	3	2		1	8
Median	215.4	0.6	3.8	(4.8)	1.77		99	9.2

Source: Morningstar, Edison Investment Research. Note: EJFI yield based on latest dividend declaration

The board

EJFI's board comprises four directors; three are independent and all are non-executive. The three independent directors are Joanna Dentskevich (chair), Alan Dunphy and Nick Watkins.

Joanna Dentskevich (appointed March 2017) has over 25 years of risk, finance and investment banking experience, including as director at Morgan Stanley heading its Global Customer Valuation Group, director of risk at Deutsche Bank and chief risk officer of a London-based hedge fund. She also is a non-executive director of Royal Bank of Scotland International and the London Stock Exchange main market listed company GCP Asset Backed Income Fund.

Alan Dunphy (appointed December 2016) has over 19 years' experience in the offshore financial industry. In 2014 he joined LGL Trustees, one of the leading independent fiduciary businesses in Jersey, to further develop its fund and corporate services offerings. He was previously a director at Capital Fiduciary Group in Jersey, where he was responsible for the management of a number of substantial entities and gained significant experience of a wide range of complex corporate structures.

Nick Watkins (appointed March 2017) is a partner in Altair Partners, which provides independent directors to funds and regulated entities. Previously, he was global head of transaction management for Deutsche Bank's Alternative Fund Services division.

Neal J Wilson (appointed January 2017) holds executive positions in EJFI Manager and co-founded its parent, EJF, so while being a non-executive director of EJFI, he is deemed non-independent. Mr Wilson served as senior managing director for both the alternative asset investments and private wealth management groups at FBR. Prior to joining FBR, he was a senior securities attorney at Dechert LLP and a branch chief at the US SEC in Washington, DC.

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