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Honeycomb Investment Trust

HONY aims for an 8% yield from asset-backed lending and has so far weathered the pandemic well...

Update
17 December 2020

Summary

Honeycomb Investment Trust (HONY) aims to generate a dividend yield of 8%, paid quarterly, by lending money to innovative non-bank lenders, secured against their loan books. The yield target has been met or exceeded every quarter since launch in 2015, and has continued to be paid through the pandemic (see the **Dividend section**).

HONY is managed by Pollen Street Capital (PSC), an investment manager which specialises in non-traditional finance. PSC uses its extensive experience in the space as well as bespoke IT systems to help identify and monitor the best of the non-bank lenders which have proliferated in recent years.

HONY's model is very distinct from platform lending (see the **Portfolio section**), and involves senior lending to non-bank lenders secured on their portfolio of loans rather than directly acquiring loans from lenders. PSC has continuous oversight of each borrower's entire book and tracks it on a month-by-month basis, altering how much HONY lends and therefore how much its investee can lend. Furthermore the underlying loans are often very short-dated, meaning that as the economic outlook darkens the lenders can run down their books and return cash. Thanks to these features, HONY has yet to register a negative quarterly NAV return, as we discuss in the **Performance section**.

In order to generate such a high yield, HONY employs gearing, aiming for 50% to 75% on an NAV basis. Facilities are flexible, allowing for rapid expansion or contraction of the balance sheet.

HONY's discount has narrowed in recent months as risk appetite has returned to the markets, and it is 4.5% at the time of writing.

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Analyst's View

The performance of HONY's portfolio since launch has been extremely impressive. The high yield has been consistently generated and NAV maintained, even through the current pandemic. Naturally, investors are likely to be wary of the immediate future. However, we think the indications from the portfolio are good so far. Although some of the underlying loans went into forbearance in Q2, the vast majority are performing once more and importantly the structure of the loans provides significant protection.

We think the counter-intuitively defensive characteristics of the asset class might be missed by some. As much of the underlying portfolio is extremely short-dated, lenders are able to stop new lending and build up cash quickly. This, and the flexible gearing facilities, means the managers have the wherewithal to expand the portfolio once more. They report the pipeline of potential investments already looks promising, as projects mothballed prior to the pandemic get under way.

We recognise a second round of lockdowns creates uncertainty in the immediate future, and this complexity is another reason the discount might persist. However, the overhang of stock held by Woodford and Barnett has long since been cleared, and so should no longer be an issue. HONY offers equity-like returns in income, should it navigate the coming six months as it has the past six.

BULL
An extremely high yield target which has so far consistently been met
Defensive elements of the strategy have led to strong portfolio performance in the crisis so far
Specialist team with extensive experience and deep resources, allowing the trust to operate in a niche area

BEAR
Fees are high, with a management fee charged on GAV and a performance fee
Gearing is high, raising the sensitivity of NAV to valuation movements
Opportunity set is complicated, information on the portfolio hard to find and the trust might be considered difficult to understand

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Portfolio

Honeycomb Investment Trust (HONY) lends to non-bank lenders, secured against their assets, in order to generate a targeted net yield of 8%. HONY can generate this high yield, net of costs, thanks to its manager Pollen Street Capital's specialist knowledge of innovative financial services companies, experienced team, bespoke IT and use of gearing. Importantly, the yield HONY offers compensates for liquidity risk, the specialisation of the market and various inefficiencies rather than simply reflecting exceptionally high credit risk. In fact, the structure of the lending and the markets HONY invests in means in our view that there are a number of counter-intuitively defensive features. This is evidenced by the fact that the portfolio has performed well even during the extreme economic shock of the COVID pandemic.

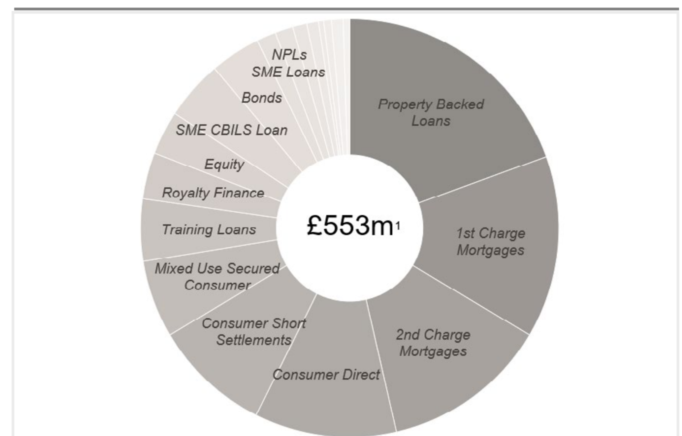
HONY aims to benefit from some of the strong secular trends of the past two decades. One is the growth of non-bank lenders. These are companies which have been established to fill the void left behind by the banking sector following the financial crisis. Trends like this continue today, with the banks still unable to serve large parts of the small business and consumer sectors as they struggle with increased regulatory burden and high cost bases.

HONY lends to these non-banks, which themselves lend to consumers and SMEs. Typically the trust provides a senior loan of 60% to 80% of the capital balance of a non-bank's loan portfolio, with the non-bank lender providing the remainder as junior equity. HONY's senior loan is backed by the loan portfolio of the underlying lender. What these loans are depends on the non-bank lender and varies from consumer receivables (consumer debt) to mortgages and business loans. As the underlying borrowers are lenders, HONY is providing facilities that are drawn down and paid back as the loan book expands and contracts. The borrowing base is therefore dynamic, with PSC only lending against performing loans. PSC monitors the health of the underlying loan books and is able to require the lender to withdraw from the market if the level of impairments is concerning. PSC structures its facilities so that a special purpose vehicle (SPV) owns the loan portfolio and acts as the borrower so that full control over the assets can be taken in the event of a default.

HONY's portfolio has 40 investments, but there are roughly 250,000 underlying loans, minimising the impact of single events. The managers select the investments after having first examined the underlying loan books in detail, selecting those whose loans have a strong profitability profile and which they believe can withstand economic shocks. In fact, as part of due diligence the team test their investments against a severe shock like the 2008 global financial crisis, and typically against a tripling of default rates. The emergence of the pandemic was just the sort of event this exercise was intended to mimic. While government support plans have so far reduced the impact of the crash on business and consumer solvency, the pandemic has presented a challenge to a portfolio of underlying loans such as HONY's. As we discuss in the **Performance section**, HONY has passed the test so far with flying colours (although we acknowledge the second lockdown and the withdrawal of support schemes next year are extra hurdles that remain to be cleared). The portfolio has benefitted from the short-term nature of the underlying loans, which means that the underlying lenders can throttle their lending and shrink their books, increasing the cash flowing back to HONY.

The below chart shows the breakdown by underlying asset. These assets are the security for the loans HONY offers, which is typically supplemented by security over all other assets of the company.

Fig.1: Asset Allocation



Source: PSC, as at 31/08/2020

Property-backed mortgages account for three of the five largest positions. These are Sancus, which provides bridging and development finance for small projects at an average LTV of just 58%, UK Agricultural Finance which provides loans against farmland, and a book of residential mortgages made by GE which has been generating 10%+ a year in run off (average LTV 67%). The largest individual position is in a book of consumer receivables made by Creditfix.

Creditfix is a good example of the sort of innovative, complicated business which HONY can generate attractive returns from. Creditfix is a business that works with consumers and lenders to restructure debts into affordable solutions to enable rehabilitation of credit profiles. The service offers the original lenders a way to recover part of their liabilities, and they pay Creditfix for taking on the costs of arranging and collecting. HONY lends against

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the contracted fees at a rate of 52%. This operates as a form of invoice discounting, with Creditfix receiving the liquidity it needs to operate while it waits to receive the fees due to it at the end of contracts/over the course of the arrangements. The loans are backed by the fees due to Creditfix, which are paid from cash flows received from the consumer and netted off what is paid over to the banks. Any shortfall is secured on the value of the business, which is estimated at approximately £200m (HONY's loan is c. £56m).

In part, banks' reluctance to operate in the market HONY operates in is due to the operating costs of doing so. Pollen Street Capital (PSC), HONY's manager, has developed bespoke IT systems which allow it to monitor and track the full portfolios of the underlying lenders in real time, which represent the crucial part of the collateral it lends against. This allows the manager to build its own assessment of the borrowing base and the amount it is willing to lend on a monthly basis, contributing to the cyclical withdrawal of credit when the economic situation darkens. It should be apparent how different this is from the platform lending space which has run into difficulties in recent years. There the funds are directly acquiring individual loans from platforms, the underwriting is outsourced and the investor has minimal control over the collateral. In HONY's model, it is insulated from individual loans in the portfolio going bad and there is a cushion which means that even if overall performance is less than expected, it is likely that performance will be sufficient to cover the return of the loan and interest. Furthermore, the non-bank lenders that HONY finances retain the 'first loss' exposure of the lending, and so their interests are in ensuring performance is in line with expectation. This is different from platform lending whereby the platform generates fees from selling the loan regardless of performance.

HONY's model is built on proprietary due diligence at the level of the lender and the underlying portfolios, made possible by the expertise of the team. The founding partners have worked together for 15 years, formerly being colleagues within the special opportunities department of RBS and having left in 2013 to form PSC (see the **Management section**).

Gearing

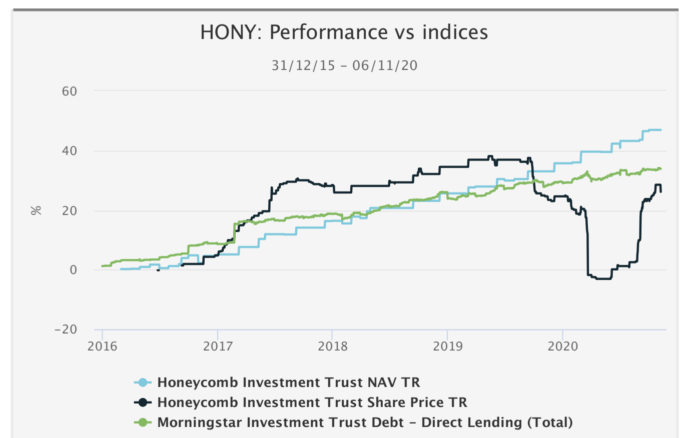
HONY targets a net gearing level of 50% to 75% of net assets in order to generate its attractive yield, although its limit is 100%. The debt is secured against the portfolio of loans. Debt facilities were recently refinanced, giving certainty of funding and liquidity for the next three years. With this there has been a one-off cost to HONY for arranging them. Total facilities offer HONY credit of £350m, or 95% of net assets. This means that the managers have extensive resources to call on as they attempt to take advantage of the improved pipeline of investments post-lockdown.

The managers de-levered the portfolio after the crisis hit in February, bringing the debt-to-equity ratio down to 0.52 from 0.58, as lenders drew in their horns and the net investment assets also fell. However, at the end of September the debt-to-equity ratio stood at 0.64, indicating the managers' comfort with the underlying performance of the portfolio and the attractive returns which are on offer.

Performance

HONY invests in loans, which means there is little potential for capital appreciation and NAV total returns reflect almost entirely the dividends generated and reinvested. Morningstar data indicates an NAV total return of 46.9% since launch, which compares favourably to the 33.6% AIC Debt – Direct Lending sector average.

Fig.2: Performance Since Launch



Source: Morningstar

Most impressively, the portfolio has seen no quarterly declines in NAV during its life. While investors may fear that direct lending is risky and a high yield indicates high risk, HONY's track record indicates reasonable stability, even through the current crisis. We believe this indicates the counter-intuitively defensive nature of the asset class. Because the majority of the underlying loans are short-dated, the underlying lenders tend to roll back their portfolio when economic times become tougher, meaning the portfolio builds up cash rather than extending further loans. Furthermore, at the same time mainstream lenders retrench from anything other than vanilla products, so specialist lenders can take on higher-quality customers. Finally, the loans are either senior secured loans, typically structured to withstand a tripling of default rates, or direct loans at conservative LTVs with security over hard assets such as property. Therefore the fund is somewhat insulated from rising defaults as there is a substantial cushion against falls in these assets' values.

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It is worth noting that the loans are recorded on the balance sheet at amortised cost with an impairment made for expected credit losses under IFRS 9 (this is the same treatment used by banks and the trust's closest peer VPC Specialty Lending Investments). Equity positions are held at fair value. Notably one top-ten position, a holding in Amigo Loans bonds, is therefore held at amortised cost rather than market value. If this position were to be marked at market value it would reduce NAV by c. 1%.

PSC believes the correct accounting treatment is to carry the position at amortised cost as the business model of HONY is to hold to collect, and the intention is not to sell it. This position has been held for some time and the approach has been signed off by the auditors, but it does indicate that there are some subjective elements of the valuation to the balance sheet in this illiquid sector. For example, the provisioning models utilise externally supplied forecast economic models from a well-respected third party, Oxford Economics. Helpfully the structured seniority of the HONY loans means that they are somewhat insulated from rising underlying defaults, with recovery values from the security likely to be high.

Post-COVID performance and market opportunity

HONY's portfolio has performed well through the pandemic so far. HONY took an impairment in March of £1.8m (0.5% of NAV) against the raised likelihood of defaults in its portfolio, but should they not transpire and the loans continue to perform this could be reversed. This would boost net income and net assets, and HONY's managers are hopeful the impairments taken will have proven to be too conservative.

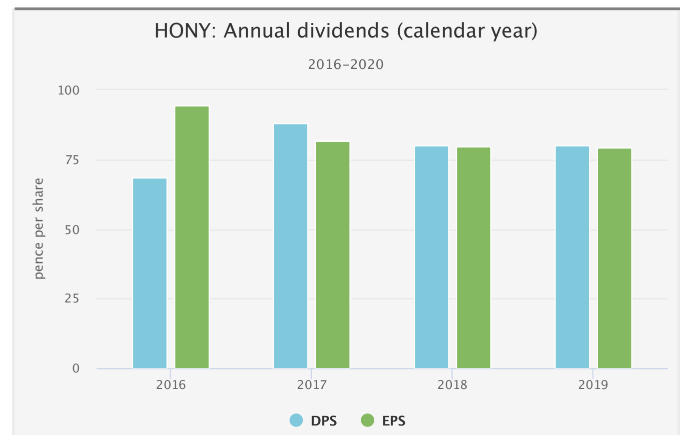
The managers tell us the real estate loans have performed well as development work has continued, and sales activity and refinancings have been strong once projects have completed. Mortgage books initially saw around 20% of loans enter forbearance by the end of June. For residential mortgages, the government mortgage holiday scheme offered borrowers the chance to delay payments, which many took. However, by the end of November over 90% of the loans which had entered a payment holiday had successfully exited across both residential and commercial mortgages. It is worth stressing that the property loans are typically extended on an average 70% LTV basis, which means that there is a substantial cushion in the event of default.

When we met with the managers recently, they were optimistic about the next few months. They reported that the pipeline for potential new investments is very full (with the pandemic having led to some projects being delayed), but these investments are now coming on stream. Some of the cash they received as the portfolio de-risked during Q2 has been used to refinance HONY's debt and implement value-accretive buybacks, but they retain funds for new investment, including the flexible gearing facilities which have just been extended. The task for the managers is to constantly reinvest capital at rates high enough to generate a geared net yield of 8%. As we discuss in the **Dividend section**, notwithstanding the lower returns in March and April, the income return for 2020 is on track to cover the dividend.

Dividend

HONY's key attraction is the high dividend yield. It aims to generate an 8% yield (or 80p per annum) on the original issue price of 1,000p, and has successfully met or exceeded that since launch without missing a beat. The 20p quarterly dividend has been maintained through the pandemic so far too, and the portfolio's robust performance means we think the prospects of it being maintained are good.

Fig.3: Dividend Return



Source: PSC

Given HONY invests in loans which should have a generally stable NAV, NAV returns can be taken as a reasonable proxy for cash generated by the portfolio. As of the end of September, HONY had generated a NAV return of 5.9% over the calendar year, equivalent to 7.9% annualised. This would put it on track to more or less cover the dividends paid this year, particularly given this NAV return is net of an impairment taken against the possibility of loans underperforming. The worst month for the portfolio came in March, when the portfolio generated a monthly return equivalent to 3% per annum after booking an impairment worth 5% per annum.

The board has extensive reserves to use in order to support the dividend through any temporary shortfall. As well as revenue reserves, HONY has a special distributable reserve worth more than two times last year's dividend. The reserves were used during Q2 and by our calculations will need to be used in Q3. However, we understand from the

managers that the performance of the underlying portfolio and the pipeline of new investments give them confidence the revenue return will remain high. We discuss the strong recovery in the portfolio in the **Portfolio section**.

Management

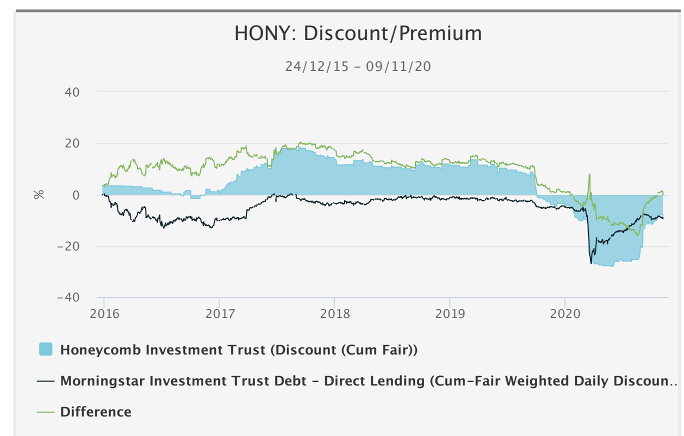
HONY is managed by Pollen Street Capital (PSC), a specialist financial services investor. PSC was founded in 2013 by a team from RBS, and the five founding partners have been investing together for 15 years. PSC began by investing in private equity and broadened into credit. Over the past five years it has invested £2.2bn in credit and generated total returns of 8% per annum on average. The private equity team have helped establish several non-bank lenders such as Shawbrook, Arrow and Sistema, as well as several service providers to non-bank lenders. The specialism of PSC's team is clearly a major selling point of HONY. PSC is able to generate extremely attractive returns from a relatively niche area which requires detailed due diligence and analytical capabilities. PSC has built software which allows its team to upload and monitor the underlying portfolios of the lenders it lends to, giving them real-time access to information about their exposures and the risks they are taking on. The strong performance in the difficult markets of 2020 doubtless owes much to the manager's expertise and preparedness.

PSC also managed Pollen Street Secured Lending (PSSL) until September 2020, which is now named Alternative Credit Investments (ACI). The management contract ended due to a poor relationship with the board, who had a dispute with PSC about the right course of action for the trust following a potential offer from a third party. The board also disputed whether it was in shareholders' best interests to recommend an offer at a discount to net assets. We note that PSC transformed the portfolio within PSSL over the three years that it managed the portfolio, changing it from an underperforming portfolio of P2P loans to a high-quality portfolio of structured positions. Furthermore, the board of HONY has publicly stated that its relationship with HONY has always been constructive and PSC's behaviour has always been reputable. HONY has made past offers to take over ACI, but we understand the likelihood is the board will seek to grow the trust organically once the discount to NAV has closed.

Discount

For most of its life HONY has traded on a premium to its peer group. In our view this has been justified by the strong returns, although the shares being tightly held by a few institutional investors likely impacted this too. Towards the end of 2019, the shares moved from a premium to a discount. This was initially due to selling by Invesco and Woodford Investment Management, caused by changes of manager and liquidity considerations in their portfolios. Similarly, some other funds in the direct lending sector have had troubled performance, and we think investors might have unfairly read across. The platform lending space has been the area of most concern, and HONY's model is very different, centring around directly held, asset-backed loans. Eventually, the pandemic saw shares in the AIC Debt – Direct Lending sector move to a wide discount as concerns about liquidity, gearing and credit performance arose. HONY moved to a wider discount than the sector, although we note that it is now once again more highly rated. HONY's shares trade on a discount of 4.5%, compared to a sector average of 6.9%. We think that should the managers' confidence in the portfolio's ability to cover the dividend prove justified – particularly if optimism returns to the UK and US economies thanks to progress with vaccines – the high yield could mean this discount closes further.

Fig.4: Discount



Source: Morningstar

Another issue that may have been weighing on the shares is the dispute with the board of Alternative Credit Investments (see the **Management section)**. We note that the chairman of HONY made a statement to the market that PSC had always behaved with integrity towards HONY, with good governance and transparency. Given the closing of the gap between the discount of HONY and that of its peer group, it seems investors might already be looking through this now resolved dispute.

The board has the ability to buy back shares in order to control the discount and add value for shareholders. Since the discount opened up in late 2019 it has been utilising this power. Having made large purchases this year (2020) on 27 January and 3 June, on 10 August the board announced it would begin a regular buyback programme. Although no size or target discount level was announced, this programme is expected to end no later than 31 August 2021. The board also has authority to issue shares when

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HONY is trading on a premium. In October HONY's shares were admitted to the main market of the FTSE in order to broaden the appeal to a wider range of investors, and this may have contributed to the narrowing discount. From 18 December HONY will enter the FTSE All-Share Index, which could further boost liquidity and lead to buying from passive funds.

Charges

HONY's latest ongoing charges figure (OCF) is 1.8% of NAV (as at 30/06/2020). This includes a management fee of 1% on gross assets. It excludes the performance fee, however, which is calculated for each calendar-year period. The performance fee is calculated as 10% of the returns made over the hurdle threshold, which is 5% annualised since launch. Excluding performance fees, the 1.8% compares to an average of 1.28% for the AIC Debt – Direct Lending investment trust sector (according to JPMorgan Cazenove). The latest KID RIY figure is 4.92%, calculated over a recommended five-year holding period. This compares to a 1.67% sector average. This includes trading costs of 1.5% per annum and estimated performance fees of 0.73%, with the remainder being the interest payments on the debt, other third-party costs and management fees. Clearly HONY is not a cheap option, but we believe the consistent net returns since launch are attractive.

ESG

PSC is a signatory to the UN Principles for Responsible Investment, and has aimed to integrate ESG issues within its investment process. For HONY, potential investments are assessed for their social impact. This is arguably a key issue to consider when it comes to consumer lending, and PSC aims to identify lenders whose products are beneficial to consumers rather than harmful. Governance is also a key area of concern, and PSC requires full transparency from lenders, as well as being able to monitor governance on an ongoing basis.

As well as a pre-investment report, the team write quarterly ESG monitoring reports for each investment. PSC has clearly thought about the areas in which its portfolio can have the most impact, and these include financial inclusion, supporting regional economies, reducing the impact of financial crime and promoting diversity.

Outside the investment portfolio, PSC has also developed a 'Ten Years' Time' initiative, partnering with social and environmental impact organisations/charities to try to make a positive difference to society. Current partners are Big Issue Invest and Blue Ventures. The initiative was launched in the inaugural ESG report published in 2019.

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