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Interest-income trio

Evan Lorenz writes:

The market has crashed, and so have government-bond yields. Now where to turn for a modicum of income at an acceptable level of risk? The preferred shares of mortgage REITs and a revisit to Solar Capital Ltd. (SLRC on the Nasdaq) are the investments under the *Grant's* lens.

At first glance, mortgage REITs seem almost self-explanatory. They leverage up to buy mortgage-backed securities (MBS) and, under law, remit at least 90% of their taxable income to shareholders. Unfortunately, the American mortgage is a landmine of options. Borrowers have the right to prepay and they do so at what, for the investor, is the most inconvenient time. (For more on how prepayments, volatility and interest-rate spreads impact the sector, see the issue of *Grant's* dated Dec. 13, 2019.)

Mortgage-REIT preferred shares, by contrast, are a model of simplicity: They pay a stipulated coupon once a quarter. Most are perpetual securities though callable after five years. During the first half-decade of their existence, the preferreds pay a fixed coupon, which afterwards resets to a spread above the three-month London interbank offered rate (Libor), or its successor rate. And, because the preferreds sit above the common equity in a REIT's capital structure, they are protected from much of the volatility in the MBS market.

The AGNC Investment Corp. Series F 6⅛ cumulative preferred (CUSIP: 00123Q872) is our first specimen. Issued at par on Feb. 4, the Series F shares have collapsed by 32% to $16.89, a price to yield 8.6%. After April 15, 2025, the stock becomes callable and the coupon changes to three-month Libor plus 4.697%. At year-end, $106.3 billion of AGNC's $107.9 billion portfolio comprised MBS issued by Fannie Mae or Freddie Mac, with the balance made up of mortgage securities in which AGNC bears the credit risk if a mortgagee defaults. While AGNC's debt footed to 9.4 times equity as of Dec. 31, net income of $1.7 billion last year covered the $54 million in preferred interest payments 32 times over.

Specimen No. 2 is the Annaly Capital Management, Inc. Series F 6.95% cumulative preferred (CUSIP: 035710870). Priced at $18.72, the Series F yields 8% today. These preferreds are callable on Sept. 30, 2022, after which the coupon shifts to three-month Libor plus 4.993%. While agency MBS accounted for 89% of Annaly's $127.4 billion investment portfolio, the REIT also dabbles in non-agency residential loans, commercial real-estate loans, corporate debt and a myriad of other paper. Somewhat mitigating the complexity, borrowings foot to 7.2 times equity. Last year, Annaly's net income of $2.2 billion covered preferred interest of $136.6 million by 15.8 times.

Business-development companies lend money to private-equity-sponsored borrowers too small to tap the widely syndicated loan market and, like REITs, must pay out 90% of their bottom line. Since Feb. 20, the S&P BDC index has collapsed by 41%. In other words, the sector looks cheap even if buying a portfolio of so-called middle-market loans is not at the top of your priority list.

Enter Solar Capital Ltd., a long-time click-to-pick (see issue dated Oct. 16, 2015). Since the p.e.-sponsored lending has hotted up, Solar has spent the past half-decade diversifying away from the middle market. As of Dec. 31, loans to buyouts filled 25% of the portfolio, with the balance in asset-based loans (35.7%), loans against capital equipment (22%) and loans to the life-sciences industry (15.9%).

The Solar portfolio is tilted towards senior loans, with 90.7% of the portfolio in first-lien, 7.9% in second-lien and 1.4% in equity or equity-like securities. At last report, 98.4% of the portfolio at cost was performing (adjusting for write-downs, 99.5% of the portfolio was performing).

By law, BDCs are allowed to use $2 of leverage for every dollar of equity they hold. At year-end, Solar's leverage ratio was 0.64:1. "Solar's relatively low current and average leverage is deliberate," Michael Gross, co-CEO and chairman of Solar, said on the Feb. 21 earnings call. "We are significantly below most of our BDC peers, and it is a reflection of our conservative approach and defensive portfolio positioning and what we believe is the latter stages of the current credit cycle. We intend to move closer to our target leverage range of 0.9 to 1.25 times, but only as the market opportunity presents itself." To aid in that ambition, SLRC has access to $600 million in untapped credit lines.

Even so, SLRC's share price has sunk 39% since Feb. 20, in line with its more leveraged and more LBO-exposed peers. The stock is priced to a 12.7% dividend yield and 60% of book value, i.e., the market has already priced into the portfolio substantial credit problems. Investors have not, however, priced in any upside for Solar being able to extend credit as loan spreads explode higher. With six buys, three holds and no sells, the Street is friendly to SLRC. Over the past 12 months, insiders have purchased a net 80,275 shares at a cost of $1.5 million.

"It appears to us that the BDC selloff has been wholesale and largely indiscriminate," Richard Pivirotto, head of investor relations and business development at Solar Capital, reports by email. "We have worked very hard to build a defensive portfolio that has very limited exposure to cyclicals in our [p.e.-sponsored] lending—we've largely avoided consumer discretionary, oil and gas, hotels, travel, leisure, retail (with the exception of [asset-based lending]), entertainment and gambling. Those industries will be hardest hit, but a broad and deep recession will inflict pain on almost all leveraged companies."

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