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Closed End Funds

Oxford Lane Capital: The Rest Of The Story ('Business Value' Versus 'Paper Value')

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Marketplace Bio

Summary

- Oxford Lane Capital surprised investors recently when it announced its estimated NAV had dropped almost 4% from a month earlier.
- This seemed out-of-step with this year's positive story about collateralized loan obligations (CLOs) and the corporate loan market generally, and OXLC in particular.
- Especially given OXLC's recent 11% distribution increase, and the strong distribution coverage outlined in its recent semi-annual report.
- Investors scratching their heads may be pleased to learn that a CLO's "paper value" may not truly reflect its actual "business value."
- To put it bluntly, a drop in loan prices that reduces the theoretical value of a CLO's equity, at least on paper, may also increase its profitability.

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[This article was published about a week ago for our Inside the Income Factory members.]

OXLC: "The Rest of the Story"

Some owners of Oxford Lane Capital (OXLC) were probably surprised to see the fund recently announced its net asset value ("NAV") for the end of November which was almost 4% lower than it was a month earlier.

Here was the announcement:

> "Oxford Lane Capital (NASDAQ:OXLC) estimates net asset value as of Nov. 30 to range between $6.84 and $6.94; this is compared to the estimated range of $7.11 and $7.21 as of Oct.31."

This may strike many investors as surprising, because the trend all year had been for CLO funds, like OXLC and Eagle Point Credit (ECC), to announce rising NAVs, reflecting the positive trend in the credit markets generally and the corporate loan market in particular. OXLC, for example, just announced last month an 11% increase in its monthly distribution, out through March 31 of next year, so the last thing many investors may have been expecting was an announcement that the fund's net asset value has decreased in the interim.

And to muddle the picture (but in a positive way) even more, OXLC's semi-annual report was just sent out to shareholders yesterday, and showed distribution coverage, both by net investment income ("NII") and by overall GAAP income (i.e. with realized and unrealized gains included), to be stronger than ever, at 119% and 332% respectively. (See below for more details.)

[Note: CLOs are "virtual banks," securitized vehicles that, along with pension funds and other institutional investors, are the main investors in loans syndicated by major banks like Bank of America, Citibank, JPMorgan Chase, Credit Suisse, and others, to the largest corporate borrowers across the US and throughout the world. For details about how CLOs are structured and their internal risk/reward dynamics, check out this article.]

I have no special insight into OXLC's accounting or valuation methodology for estimating the "market value" of the individual CLOs that it holds, which it then adds up to calculate its own net asset value. But I can say that estimating CLO values is very much an art as much as a science. CLOs were created about 35 years ago, because I remember writing about some of the early versions of them as a reporter for Investment Dealers' Digest (IDD Magazine) back when I was making my mid-life career switch from banking to journalism (which later became a switch back to credit and finance, and again more recently back to journalism, or whatever this is).

Without getting into too much detail, the important things to recognize are that:

- For their first 20 years or so, nobody even made much attempt to evaluate or "mark to market" a CLO once it was created and placed with investors (who were all institutional investors at that time, not retail investors).

- CLO debt and equity were "privately placed" with pensions, insurance companies, endowment funds and other large-scale investors, who bought it, held it to maturity for its cash flow, which they calculated a return on as they received it, some years higher than others depending on interest rate levels, default and loss experience, prepayment and reinvestment rates, and other market and portfolio-specific factors that affected a particular CLO's total return.

- The returns were attractive, and typically were in the low double digits or even higher, which made CLOs an attractive way for institutions to earn what was an "equity return" from a credit-based instrument that had a more predictable and "model-able" cash flow and return profile.

- But there was little or no attempt to "mark to market" the equity or debt of CLOs, because, like other issues in the private placement market, there was little or no trading of the issues once they were placed. In fact, institutional investors liked the idea they could put them in their portfolios, collect the principal and interest, and not worry about the sort of market fluctuation and volatility that came with their equity investments.

- Once CLOs were introduced to the retail investing community, about a decade ago by OXLC, and shortly afterward joined by ECC, the game changed as far as having to come up with a regular "mark-to-market" estimate, since retail funds need them, whether they are available or accurate or not.

That's the situation we now find ourselves dealing with, as investors. It is relatively easy to come up with an estimate of the theoretical "market value" of a CLO's equity. A CLO owns a portfolio of loan assets, most of which have a trading price (which itself may be an estimate, since lots of loans don't trade that much, although many of the larger ones do). CLOs also have debt, in tranches rated triple A, double A, single-A, and right on down through double-B, depending on where it is in the pecking order to get paid first or last when the CLO is ultimately liquidated. The amount of the debt is fixed and doesn't change throughout its life until it is repaid.

That means the assets of the CLO (i.e. its loan portfolio) move up and down in market value as their prices change. But the liabilities (i.e. the debt) stay the same. And like every fund or company, the equity is what rises and falls to make up the difference.

So if the assets of a CLO (or a bank, etc.) were worth $100 million, and the debt of the CLO or bank was $90 million, then the equity would be worth $10 million. If the following month the loan assets went up in value to $101 million, the debt would still be worth the same $90 million (i.e. the amount the CLO owes to its creditors doesn't change just because its assets are worth more or less), and so the equity would be worth $11 million, getting the benefit of the $1 million increase in the worth of its assets. Of course if the loan assets dropped in market value to $99 million, again the debt wouldn't change, so the decrease in value would come off the equity, which would now be worth only $9 million.

Business Value vs. Paper Value

That sounds, and is, pretty straightforward. But it doesn't tell the full story, as I explain in my "CLOs for Dummies" article referenced above. A drop in loan prices may make a typical CLO appear - on paper - less valuable than it was previously. But remember that the loan whose price may drop to 95 cents on the dollar, or even lower when markets are under pressure for all sorts of extraneous reasons (Covid outbreaks, for example), in 99% of the cases that loan is still paying its interest and principal and fully performing, regardless of how the secondary loan market prices it.

If you are managing a CLO portfolio, with dozens or hundreds of these healthy loans, you have a certain number of them repaying principal or even pre-paying the entire loan prior to its stated due date. CLO managers often love it when borrowers prepay and they get to re-invest the proceeds in new healthy loans that they can buy in the secondary loan market, especially if the "replacement loans" they are buying have had their prices depressed because of extraneous reasons that seldom reflect that loan issuer's ability to service and repay its own debt.

So CLOs, during the very periods when their own loan portfolios may have dropped in value (on paper), are able to reinvest their cash flow in new loans they purchase on the secondary market at bargain prices. That means they get higher coupon rates on those loans than they would if they bought them at par, plus they get a capital gain a couple years later when that loan they bought at 95 cents on the dollar pays off at par.

In short, we have a situation where:

- the theoretical market value of CLOs (and the funds that own them) may have dropped, but
- the CLOs' "business value" has actually increased, because

the "raw material" they purchase (i.e. new loans for their portfolio) has become cheaper on the secondary market.

I suspect few retail investors in OXLC will appreciate this as they see the headline news about OXLC's estimated NAV dropping over the past month.

But Wait, The Story Gets Better!

Since announcing the NAV estimate yesterday, OXLC has come out with its semi-annual report. Looking at its income for the past 6 months and previous 12 months, the story - in my view - gets even better. Here is a summary of the earnings and, in particular, the distribution coverage figures for the two periods:

Oxford Lane Capital (in $ Millions)	6 months to 9/30/2021	12 months to 3/31/2021
Net Investment Income	52.1	76.4
Realized & Unrealized Gains	93.4	213.5
Total Return (i.e. GAAP Income)	145.5	289.9
Distributions to Shareholders	43.9	86.3
NII Coverage	119%	89%
GAAP Coverage	332%	336%

For the most recent 6 months, OXLC covers its distribution (which was recently increased, as mentioned up above) by 119% with its net investment income ("NII") alone. When you include the appreciation on its portfolio, realized and unrealized, that coverage goes up to 332%.

Look forward to your comments, questions and insights, as usual.

Steve

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Thanks,

Steve Bavaria