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Closed End Funds

KYN: Merger With FMO Could Face A Hurdle

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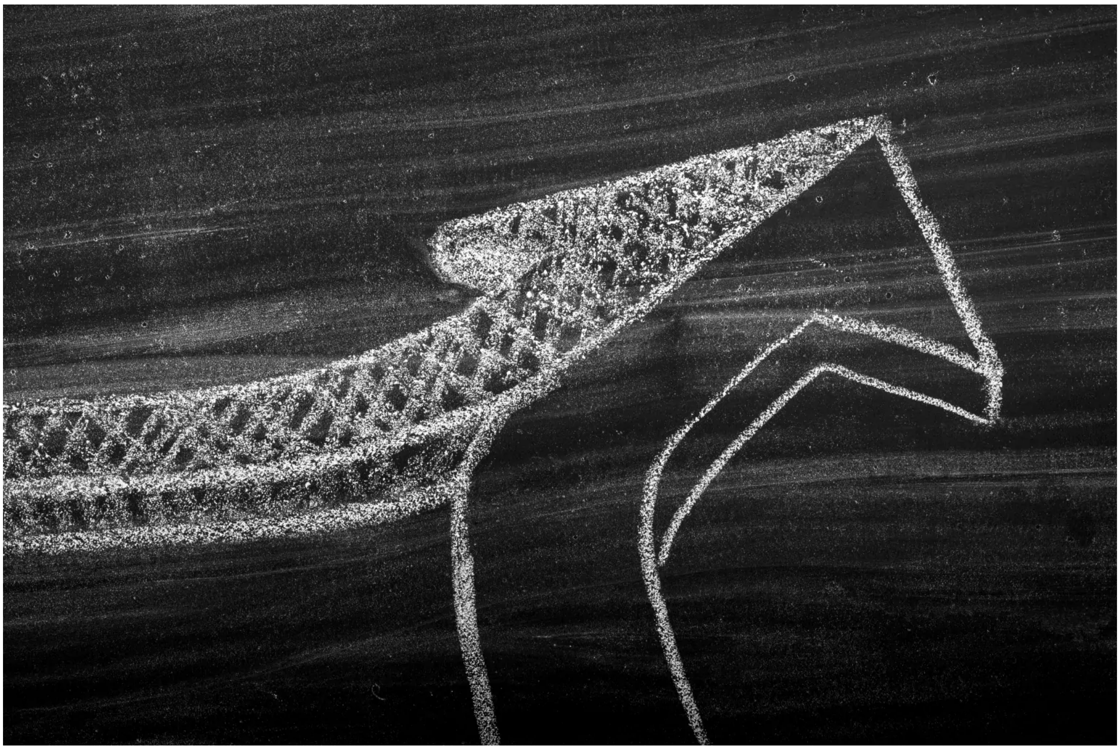
Nick Ackerman
Marketplace

Summary

- In an interesting set of events, KYN and FMO have agreed to enter into a merger.
- This is a unique situation, because these are two different fund sponsors in the CEF space.
- FMO is sub-$100 million in AUM, Guggenheim probably doesn't see FMO as worth their time.
- This idea was discussed in more depth with members of my private investing community, CEF/ETF Income Laboratory. Learn More »



marrio31/iStock via Getty Images

Written by Nick Ackerman, co-produced by Stanford Chemist

In an interesting set of events, Kayne Anderson Energy Infrastructure Fund (KYN) is set to absorb and merge with Fiduciary/Claymore Energy Infrastructure Fund (FMO). This was announced on September 15th, 2021, and we haven't received too much in the way of updates since.

Mergers in the closed-end fund space happen all the time. That isn't what makes this one interesting. What makes this one particularly notable is that this is across fund sponsors. Typically, fund sponsors will fold funds into one another within the same family.

In this case, Guggenheim is essentially giving up FMO just to get rid of the fund. Offloading to Kayne Anderson means they won't have this energy fund plight on their hands. Since FMO has under $100 million in total managed assets, that is probably a strong determining factor in just getting rid of it.

Unlike corporations that merge, CEFs do so with what we call a NAV for NAV exchange. That means the NAV of each fund determines the ratio. In that way, the investor's value of their holding stays exactly the same. That's why for this merger, it is Guggenheim just handing these assets over.

> As a result of the merger, the outstanding common stock of FMO will be exchanged for newly issued common stock of KYN. The exchange ratio will be based on the relative per share net asset values of FMO and KYN immediately prior to the transaction's closing date. Based on each fund's current per share net asset values, KYN expects to issue approximately 9.3 million shares of common stock to FMO's shareholders.

Here's the hurdle that the fund may face, it goes to a shareholder vote. At this time, the filing was posted, but it is needed to be completed. The shareholder meeting will presumably take place in 2022 at 10 A.M., but an official date has not been established at this point, according to the filing.

Kayne Anderson

Kayne Anderson Energy Infrastructure Fund, Inc. (NYSE: KYN)
Fiduciary/Claymore Energy Infrastructure Fund (NYSE: FMO)

Dear Shareholder:

You are cordially invited to attend the Special Meeting of Shareholders (the "Meeting") of Fiduciary/Claymore Energy Infrastructure Fund ("FMO") to be held on:

, 2022
10:00 a.m. Central Time

(Source - Proposed Offering Filing)

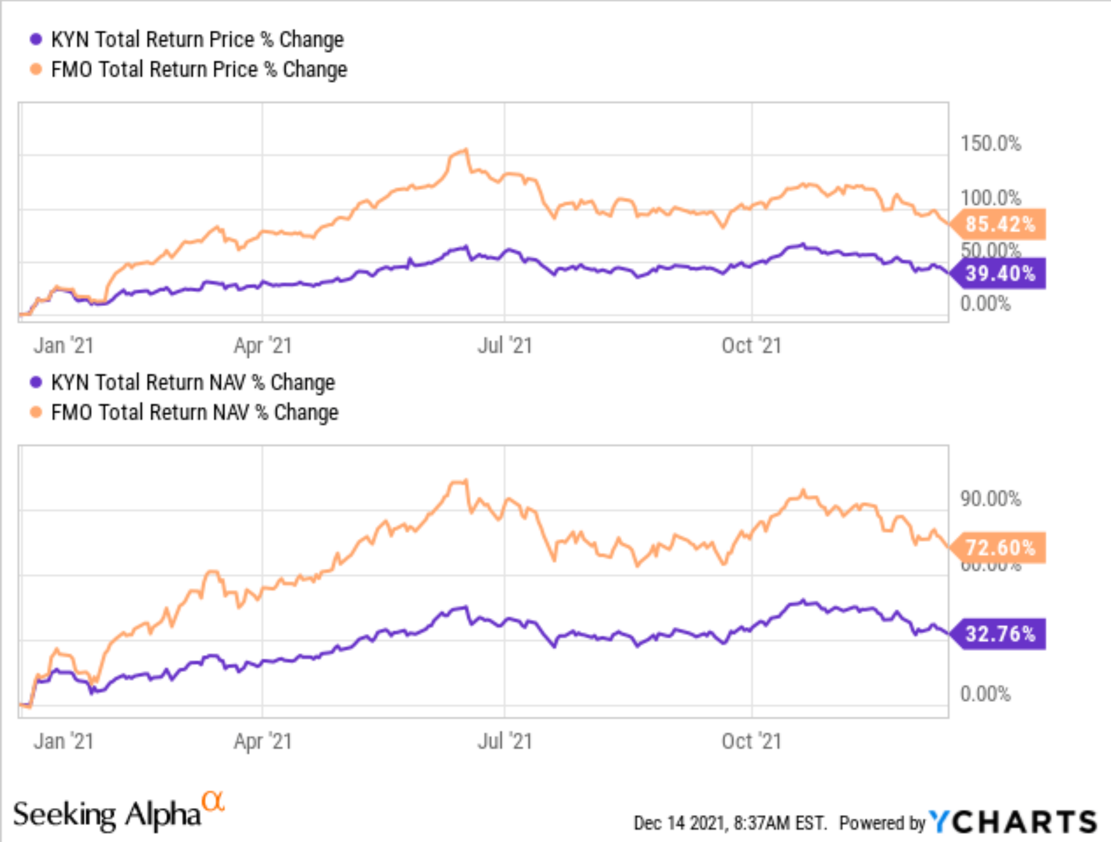
Here's The Hurdle(s)

Both funds have performed terribly over the last several years as energy has been the worst-performing sector by far. That being said, it was more of a function of what they are invested in rather than terrible management. As a reminder, CEFs are wrappers, and they are only as good as their underlying investments. Some funds, KYN and FMO being such funds, invest specifically in sectors. They were investing in the best of what they could - but still came up short.

That being said, over the last year, FMO has performed to a much higher degree than KYN. I believe that is one of the major hurdles that the funds will face to get this merger through shareholders. In addition to that, since FMO is such a small fund, they will probably struggle to reach out to shareholders just to get enough votes.

It is worth noting, in this merger, only FMO shareholders need to vote. KYN shareholders do nothing. The fund is getting free assets, so really, there is no downside for investors here.

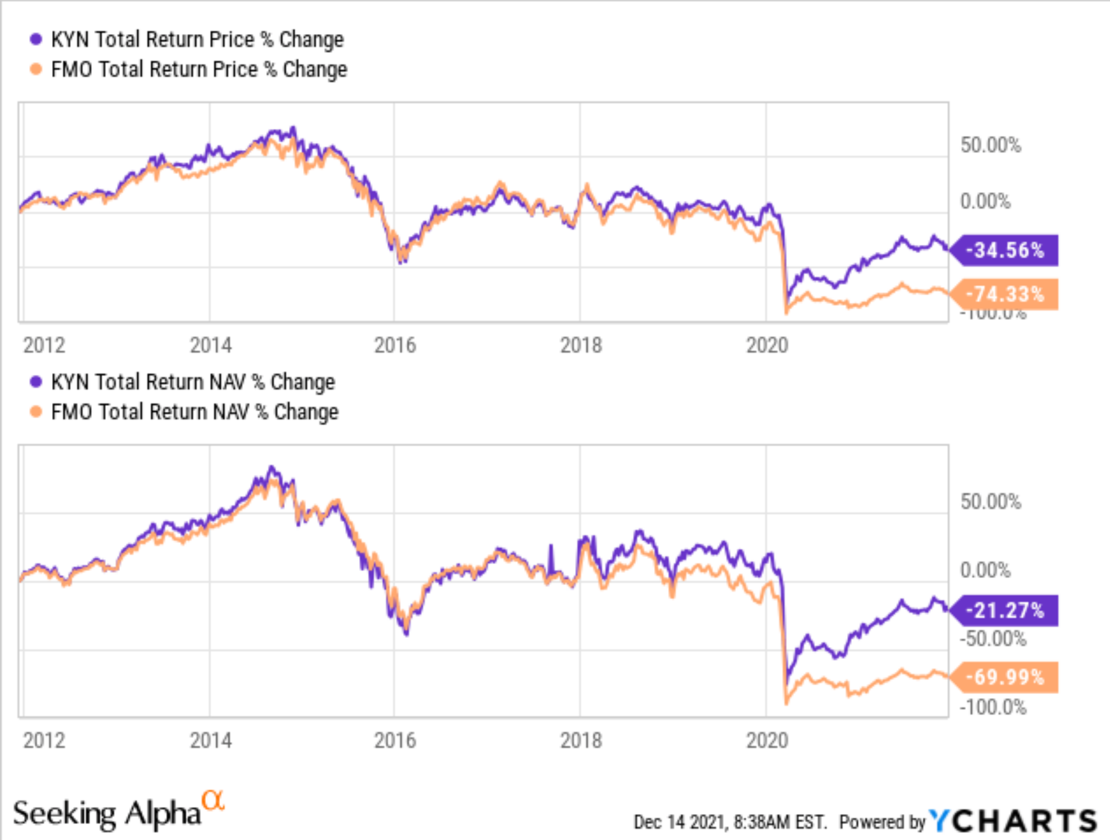
Here's the performance on a YTD basis through 2021, which is practically a whole year now.



Data by YCharts

This performance difference was achieved with less leverage as well. KYN is leveraged around 23% and FMO at approximately 15.6%, according to CEFConnect.

That being said, KYN has outperformed over the longer term. The chart below shares the performance for the last decade. Again, neither fund has done well due to energy. However, KYN has performed significantly better.



Data by YCharts

It really began to diverge after 2020's COVID crash. At that time, FMO performed in a spectacularly terrible fashion. The fund's total NAV return performance for 2020 was -81.60%. KYN's total NAV return was -48.52%. Spectacularly terrible, but not as spectacularly terrible.

That's why FMO is performing so much better this year, in my opinion. It is because they are rebounding from when they dropped further.

FMO reduced leverage significantly in 2020. That's why their leverage is so low now. Because they are hoping to be merged away, they aren't likely to be looking to increase leverage or really take the fund's management too seriously.

	Six Months Ended May 31, 2021 (Unaudited)	Year Ended November 30, 2020	Year Ended November 30, 2019[g]	Year Ended November 30, 2018[g]	Year Ended November 30, 2017[g]	Year Ended November 30, 2016[g]
Senior Indebtedness:						
Total Borrowings outstanding (in thousands)	$ 5,192	$ 5,192	$ 93,000	$ 118,000	$ 118,000	$ 183,000
Asset Coverage per $1,000 of indebtedness[f]	$ 17,982	$ 11,597	$ 3,955	$ 4,179	$ 4,485	$ 3,715

(Source - FMO Semi-Annual Report)

KYN also reduced their leverage but added it back as fast as they could throughout the year.

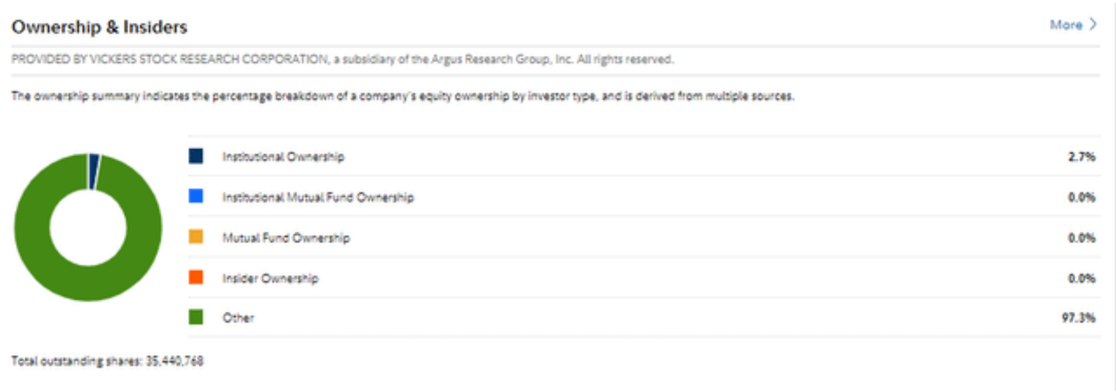
	For the Six Months Ended May 31, 2021 (Unaudited)	For the Fiscal Year Ended November 30,		
		2020	2019	2018
Notes outstanding, end of period[10]	$ 226,163	$ 173,260	$ 596,000	$ 716,000
Borrowings under credit facilities, end of period[10]	$ 92,000	$ 62,000	$ 35,000	$ 39,000
Term loan outstanding, end of period[10]	$ —	$ —	$ 60,000	$ 60,000
Mandatory redeemable preferred stock, end of period[10]	$ 101,670	$ 136,633	$ 317,000	$ 317,000
Average shares of common stock outstanding	126,447,554	126,420,698	126,326,087	118,725,060
Asset coverage of total debt[11]	494.8%	529.1%	399.9%	392.4%
Asset coverage of total leverage (debt and preferred stock)[12]	375.0%	334.7%	274.1%	282.5%
Average amount of borrowings per share of common stock during the period[1]	$ 2.26	$ 2.88	$ 6.09	$ 6.52

(Source - KYN Sem-Annual Report/Cropped by the author for clarity)

The reason to bring up the borrowings is that it helps highlight that it wasn't just all rebounding from a more considerable low last year. Some of it was just better investment selection as well.

To sum it up, I believe that recency bias, with FMO performing so much better over the more recent term - will make it hard to get investors to sign off on the proposal. The fact that it is a smaller fund means that it could be that much harder to get investors to vote in the first place.

According to Fidelity, FMO has very minimal institutional ownership. Those are the investors that generally pay attention to their investments.



(Source - Fidelity)

Why The Merger?

In the original announcement, the CEO of KYN had this to say:

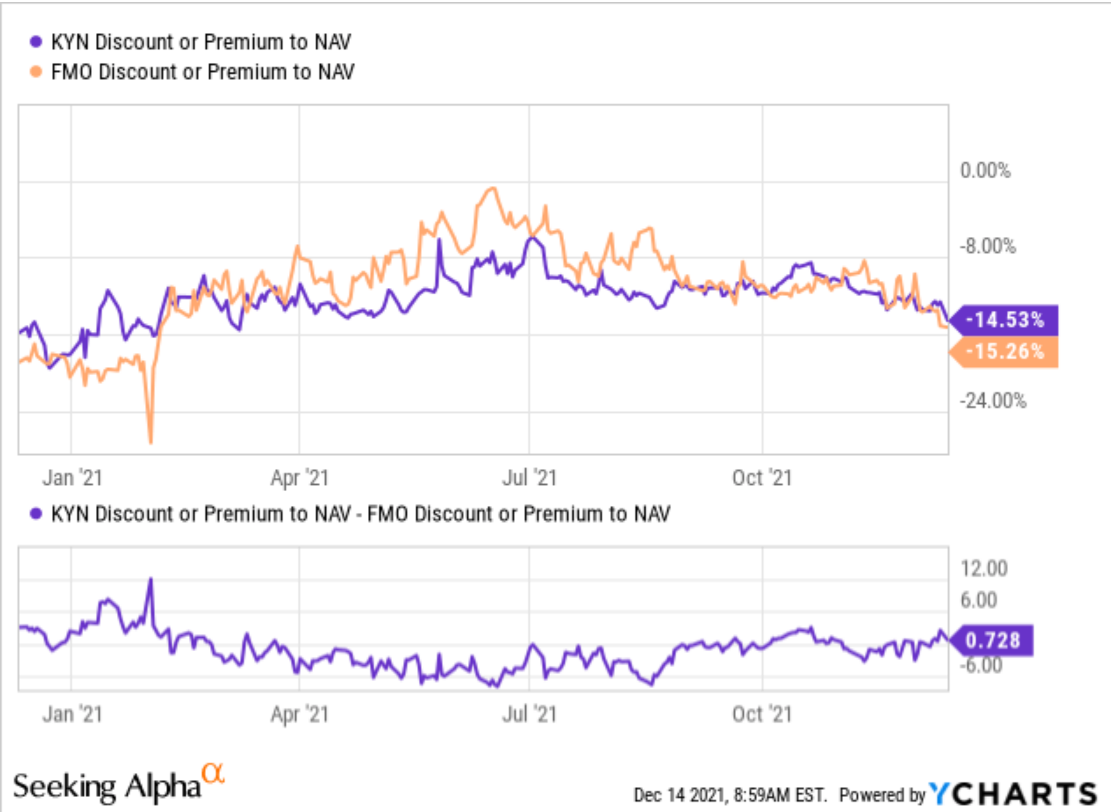
> Jim Baker, President, CEO, and Chairman of KYN said, "We are pleased to announce this transaction, which we believe is in the best interest of our stockholders. We believe the merger is a tax-efficient way for FMO's stockholders to continue investing in the energy infrastructure sector through KYN's large and diversified portfolio. As the largest closed-end fund focused on energy infrastructure investments, we believe KYN is a natural consolidator. Our investors should benefit from the potential cost savings that come with increased size and scale, enhanced trading liquidity, "best in class" access to the capital markets, and additional investment opportunities as we look to capitalize on the energy transition."

That leaves it fairly generic. It will make the fund a bit bigger, but with so few assets in FMO, it won't likely reduce expenses materially. With that, I just don't see any reason why, but Guggenheim just wants to exit this fund. One of the positives for FMO shareholders, if approved, would be greater liquidity. It would allow them to buy and more efficiently.

Guggenheim doesn't have many closed-end funds in the first place. They also just recently consolidated some of their funds into the Guggenheim Strategic Opportunities Fund (GOF).

What makes this even more interesting is that Tortoise Capital Advisors is the current portfolio manager. That makes it surprising to me why it isn't going to be folded into a Tortoise fund - or if there was a discussion, why did it break down?

One other benefit that investors should watch is the discount difference from the funds. At this time, it isn't a huge spread.



Data by YCharts

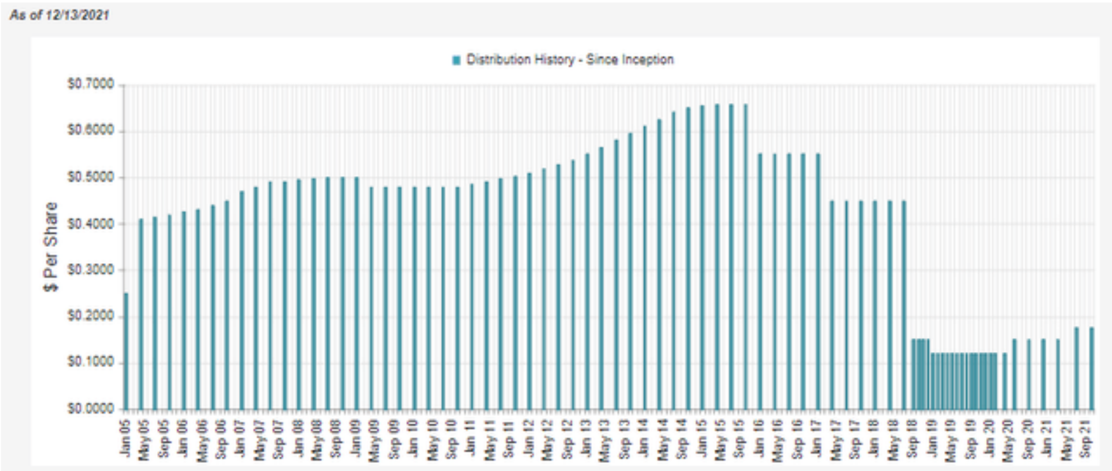
You would want to watch this because, if approved, shares of FMO should start trading around KYN's discount level. That means if FMO was trading at a 20% discount and KYN was at a 10%, that could be a chance at a quick 10% profit. In this case, the spread between the fund is so narrow, and the risks of it falling through quite high, it doesn't make much sense to buy FMO. At least, in terms of trying to capitalize off of this merger. One might be looking for energy exposure, and FMO could be a worthy candidate in that regard.

Anything Changing?

As far as it goes, when the funds are merged, nothing is changing for KYN. The investment objective and portfolio investment policy are all staying in place. Additionally, they commented on the distribution of KYN. That isn't going to change either.

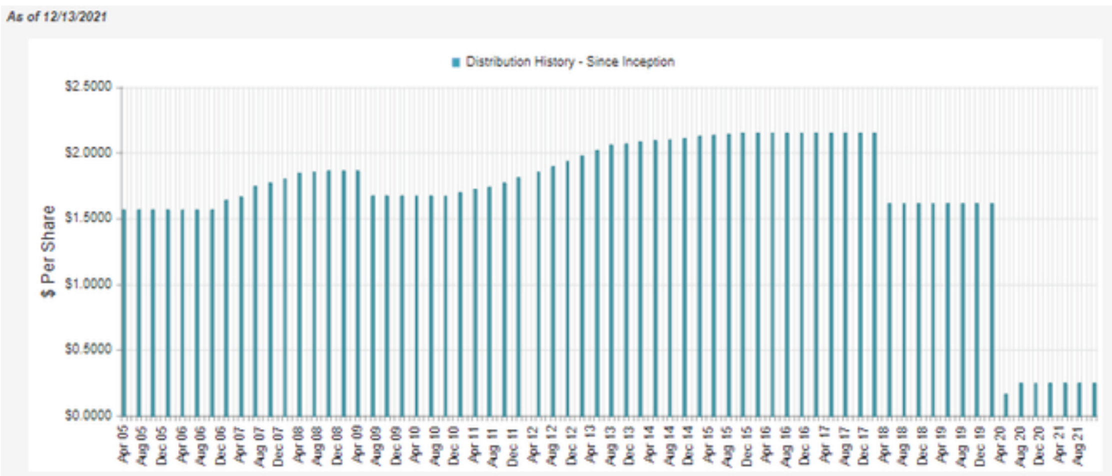
> "KYN's distribution policy, which considers net distributable income as well as realized and unrealized gains from KYN's portfolio investments when determining KYN's distribution, will remain in place after completion of this transaction. We recognize that distributions are a significant part of the value proposition that KYN provides to its investors, and one of management's most important long-term goals is to provide the Company's investors an attractive distribution", concluded Mr. Baker.

Since KYN is structured as a C-corp - and not a regulated investment company [RIC] that most CEFs are - there is no requirement to pay out distributions to shareholders. In practice, though, funds know that investors buying CEFs are looking for distributions. So not offering a distribution or an attractive one would lack investor interest. The current distribution yield of KYN comes to 9.30%.



(Source - KYN Distribution Chart, CEFConnect)

FMO is just over the psychologically important 10% level, at 10.08%. The overall pattern of the distribution changes for each fund has been similar.



(Source - FMO Distribution Chart, CEFConnect)

Conclusion

This is a peculiar merger in the CEF space, so I wanted to touch on it. As long as I've been paying attention, I've never seen a merger between two different fund sponsors. The reason being is that it is Guggenheim essentially giving assets away. In this case, the fund being sub-$100 million in assets is likely the reason why Guggenheim would instead just do away with the fund.

Overall, the merger isn't a reason to buy into KYN or FMO. Instead, looking at these in terms of wanting energy exposure for your portfolio would be the only reason worth looking at these funds. Not to mention that I believe the merger vote might be hard to get passed through shareholders. That is for the recency bias of much better performance for FMO, and smaller CEFs have a more challenging time getting a hold of enough shareholders to vote.

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Additional disclosure: This article was originally published to members of the CEF/ETF Income Laboratory on December 14th, 2021.