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MMAC: A Reinvented Company with Significant Upside

Summary

- Company is transitioning capital from its Leveraged Bond portfolio to the higher-margin and shorter-duration Energy Capital business
- External manager, Hunt Investment Management, and existing MMAC management team have significant incentive to drive increases in MMAC book value per share
- Company has several undervalued assets and an overvalued liability
- Shares are trading at a roughly 30% discount to book value and have significant upside with multiple catalysts

A Reinvented Business

MMA Capital Management, LLC (MMAC) used to operate several businesses, have investments in several partnerships, and own other assets outright, all of which confused investors and led to messy financial statements. On January 8th of this year, the company made a significant step in simplifying their business. MMAC sold, among other assets, their low-income-housing tax credit (LIHTC) fund management business to Hunt Companies, Inc[i]. Along with the asset sale, Hunt Investment Management, LLC (an affiliate of Hunt Companies, Inc.) signed a management agreement that provided for MMAC to be entirely managed by Hunt – all employees including C-Suite and all G&A expenses became the responsibility of Hunt. YTD through Q3, MMAC's G&A and salary costs (including Hunt's management fee) have decreased by over 25% by virtue of piggybacking off Hunt's existing administrative infrastructure. MMAC provided seller financing for the asset sale in the form of a $57mm note due from Hunt and two equity issuances (more on both these points later).

Post-Hunt agreement, MMA Capital operates two business lines: Energy Capital and Leveraged Bonds. The Energy Capital business involves lending money to developers, contractors, and system owners of renewable energy systems in North America in a form similar to a line of credit. Generally, these borrowers have exhausted their original loans or have cost overruns and cannot return to their original lender. The company provides what is essentially bridge financing for a handsome fee. Generally, the financing is shorter than 18 months in duration and secured by the relevant system's power purchase agreements, significantly lowering the risk to MMAC. The company earns outstanding returns in this portfolio with a weighted-average rate on their loans of 9.2% and a 4.3% weighted-average rate on their debt financing.

In MMAC's second business line, its Leveraged Bond portfolio, the company purchases bonds secured by multifamily affordable housing. These housing developments, by and large, carry tenant-income and rent restrictions, ensuring their continued affordability. The bonds MMAC purchases are generally fixed-rate, tax-exempt, and unrated. To finance these purchases, the company uses total return swaps (TRS) which function similar to a margin loan. The company pays a floating interest rate tied to either the SIFMA 7-day muni swap index or 1-month LIBOR plus a premium. MMAC uses interest-rate swaps to limit rate exposure in their TRS agreements. The company earns a strong net interest margin in the Leveraged Bond portfolio with the weighted-average rate of the company's bonds and TRS-agreement financing at 6.42% and 3.0%, respectively, as of the most recent quarter. The portfolio has seen only minor delinquencies with approximately 6% of the bonds' principal balance nonperforming.

Management is in the process of transitioning capital away from multifamily affordable housing bonds to the Energy Capital portfolio. They believe the rates on new housing bonds are too low and the spread isn't satisfactory when compared to the 5%+ net interest margin on the energy capital loans. The Leveraged Bond portfolio is in run-off, and though its duration is quite long (between 17 and 30 years), the bonds have prepayment ability with 88% of the portfolio eligible to be repaid at par by 2022[ii]. As an acceleration of that process, on December 21st of this year, the company announced they had sold roughly half of the leveraged bond portfolio realizing 5% premiums to principal value[iii]. Management seems to have intelligently used the recent decreasing-rate environment to sell this block at advantageous prices.

It's difficult to have an advantage in the business of providing capital. However, MMAC does have a leg up on competition with low-cost funds in the form of its long-term subordinated debt. In the financial crisis, with the company's real estate portfolio in trouble, MMAC's lenders compromised and restructured the company's debt. Fully recovered, MMAC is now in an advantageous position with $98mm outstanding in subordinated debt due in 2035 that bears interest at 3-month LIBOR + 200 bps and amortizes 2% per year. With their multi-year rate hedges, the company is currently paying an effective 3.5% on this debt.

Aligned and Motivated Management

MMAC is led by CEO, Michael Falcone, and President and COO, Gary Mentesana. The two have been in their positions for just shy of 15 years, and both have been consistent purchasers of the company's shares (Mr. Mentesana only officially changed his title to COO in Q2 of this year). Mr. Falcone's and Mr. Mentesana's ownership increased substantially this year with ownership on their most recent Form 4s of 331k and 261k shares, respectively, representing many multiples of their yearly salaries[iv].

Management has overseen a capital allocation policy that involved significant capital returned to shareholders through buybacks. However, different than most companies, their buybacks were done only at accretive levels, which management stated to be anything less than GAAP book value. Over the past three fiscal years, MMAC spent $27.4mm on share buybacks, 20% of the current market cap. This contributed, along with their strong operating results, to a 25% CAGR of their book value per share over the same timeframe. The company has 218,750 shares available on its 2018 repurchase authorization with 187,500 shares bought in as of quarter-end. Given the shares' recent substantial discount to book value, we expect the 2018 authorization to be fully utilized.

MMAC's new external manager, Hunt is also a significant investor in common shares. To ensure alignment of interests as part of Hunt's management agreement with MMAC, the company issued Hunt two blocks of shares for an average cost per share of $33.50 and a total consideration of $8.375mm, a premium to the GAAP book value at the time. The transaction resulted in Hunt's ownership of approximately 4.3% of the company. However, Hunt is not only an investor in company shares, but has significant incentive to deliver strong results for shareholders. In the management contract, Hunt is compensated a "management fee" of 2% of MMAC's equity on an annual basis. Hunt is also able to earn an incentive fee of 20% of the change in book value *per share* each year above 7%. This disincentivizes excessive share-based compensation and shareholder dilution and further incentivizes accretive share repurchases and value-realization events.

What It's Worth

The company is currently on track to report roughly $14mm and $7mm of gross and net interest income in 2018. This spread is likely to widen as capital transitions from leveraged bonds to the higher-margin Energy Capital portfolio (absent any substantial jumps in interest rates.) The current year includes several transactions and will result in a noisy income statement due to gains/losses on assets and legal/transactional fees. Run-rate non-interest expenses, per Hunt's management agreement, should approximate $5mm-$7mm per year. This leaves net income fairly unattractive in the low single-digit millions for 2019.

However, that is likely to change. MMAC has multiple avenues that it will likely use to grow its net interest income significantly. First, the company carries a $67mm note due from its manager, Hunt, $57mm of which is from the original asset sale at the beginning of the year and $10mm from a recent transaction. This note pays 5% annually until it amortizes in equal payments over 5 years starting in Q1 of 2020. The note will be bringing in $13.4mm of interest income each year starting in 2020 for the company to deploy as it sees fit, boosting 2020 earnings to $15mm+. More important than the temporarily increased interest income is the redeployment of that capital. In 2025, when the note is fully amortized, the company should be generating at least another $3.3mm of net interest income, a 50% increase, on redeployed capital from the Hunt note alone (assuming steady net interest margins).

What's more, the company's balance sheet is very strong for such a liquid lending business, and MMAC has ample opportunity to take on more debt to grow the Energy Capital portfolio. Pro-forma, following the leveraged bond sale after quarter end, the company will carry debt of roughly $145.7mm, equating to a PF debt to equity of about 0.7x. If the company were to increase its debt load to 1.5x equity, an additional ~$166mm of debt at say, 6%, it would see $5.3mm in incremental annual net interest income.

MMAC's lending in Energy Capital, its primary business line (post-Dec 21 leveraged bond sale) is both short-duration and generally on the lower end of the risk spectrum due to power purchase agreements securing the credit lines. Management has shown with the run-off of the leveraged bond portfolio that the company is not growing for growth's sake and a keen eye is being kept on profitability. Should competition in the energy lending space increase or the rate environment change to a point that the company's operations are unprofitable, management will likely allow the portfolio to run off and return capital to shareholders or shop the company around before it would see book value per share decrease. It stands to reason that based on these points, MMAC's shares should trade roughly around book value, a 40% premium from recent prices.

There are multiple catalysts that have the possibility of increasing share price in the near future. Though the company screens fairly cheap at just inside of a 25% discount to book, this does not account for a very strong end to the year. Management stated that the final Hunt transaction, completed at the beginning of Q4, by itself would increase book value per share by about 7% or $2.35, bringing total book per share to $35.31. Notably, this doesn't even include Q4 operating results. In reality, the shares are trading at an almost 30% discount to book which could grow after Q4 results are reported. To add to this, share repurchases are likely to continue apace due to the large share price discount.

Management is also hoping to bring about an increase in share price by changing the legal structure of the company from an LLC to a C-Corp. Some institutional investors are prohibited from investing in an LLC structure. However, most importantly, LLCs are explicitly prohibited in the Russell 2000 (and all Russell indices)[v], an index that MMAC would otherwise likely be included in. The company had already changed to a corporation for tax purposes but will complete the legal change effective January 1st of 2019[vi]. The company is also boosting its spending on capital market outreach in 2019.

Hidden Value

Despite the company's significant GAAP book value compared to its market cap, company management has a habit of reporting assets and liabilities quite conservatively (staying within GAAP guidelines). In the past, they have conservatively marked real-estate holdings and seller-financing notes leading to lumpy increases in book value when fair values are realized. Motivation for this could be questioned as it is self-serving for the executives accumulating shares, but it has also allowed the company to repurchase shares at a substantial discount to the real intrinsic value of the company. This has aided the fantastic returns to continuing shareholders over the past several years. Regardless of reasoning, this practice still seems to be in place.

MMAC has NOLs with a carrying value of $140mm that, according to company estimates, could offset roughly $80mm of future income taxes under the new tax law. The company chooses to fully reserve the NOLs and doesn't carry them on the balance sheet at all despite what seems to be a high likelihood that at least a portion will be used.

As mentioned before, should the company's operations become unprofitable, it seems unlikely that management would allow the company to shed book value. If they were to shop the company around, these NOLs would have significant value to a purchaser, especially compared to the current market cap. Additionally, as mentioned earlier, the company has a strong advantage in their financing with $98mm of subordinated debt. Given the advantageous terms for MMAC and based on my conversation with the company, the carrying value of this debt could feasibly be 50 cents on the dollar.

Lastly, as somewhat of a hidden call-option, the company owns a 150-acre undeveloped tract of land just outside Winchester, VA referred to by the city as Heritage Commons. The city is currently in process of building a road extension and approving plans for a bridge (over highway 81) that will connect MMAC's land with roads in the area with significant traffic. The company carries the investment on its books at $3.7mm. However, a similar undeveloped plot a stone's throw away from Heritage Commons is asking $180k per acre. Translating that price to MMAC's land would yield a value of $27mm. It's unlikely to be worth that today, but the city has already approved and hired a firm to construct the required road with a goal end-date of next September[vii]. Once the bridge is completed in the coming years, it's likely the property will appreciate significantly.

Risks

Per my conversation with the company, the primary concern is keeping a strong pipeline of deals in the Energy Capital portfolio. Should the company not be able to keep their pipeline full or should there be new competition in the space that bring rates down, MMAC may not be able to generate growing interest income. However, given the short duration of the portfolio, the company will become liquid quickly leaving no reason to trade at a significant discount to book.

Hunt Investment Management, LLC may not turn out to be a competent manager, and the company may realize little overhead reduction from its management contract. With higher overhead, the company will likely operate at a loss. Though, it's important to note that this would run counter to Hunt's performance compensation target and would be detrimental to its investment in MMAC shares.

The company could face higher costs of funds if interest rates were to increase rapidly though this is somewhat abated by their rate hedges and caps. A combination of higher cost of funds and increased competition or lighter pipeline in the Energy Capital portfolio could lead to poor results.

Disclosures

I am/we are long MMAC.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

This article does not constitute a recommendation to buy or sell any security nor does it contain every piece of relevant information regarding the topic discussed. Any reader should make his/her own decision regarding their investments after examining all available information.

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[i] MMAC January 09, 2018 8-k
[ii] MMAC Q3 Conference Call Transcript, Seeking Alpha
[iii] MMAC December 21, 2018 8-k
[iv] Michael Falcone and Gary Mentesana Recent Form 4s
[v] Russell US Equity Indexes Construction and Methodology
[vi] MMAC November 20, 2018 8-k
[vii] Winchester City Website. Tevis Street Extension