Beware the Large Cap Dividend Trap
Passive Money Flows Creating Opportunity for Value Driven Income Investors
Part Three - September 2016

In the first two parts of this series, we analyzed discrepancies within the dividend paying equity universe. In addition, we suggested that these inconsistent valuations have been created by investors passively piling money into valuation agnostic strategies such as the S&P 500 Dividend Aristocrat Index[1] and its members. In each piece we pitted a "Dividend Aristocrat" against a company with a lower valuation, a higher dividend yield and what we considered better prospects.

Utilities comprise another sector that has experienced recent inflows. As we discussed in our second quarter letter[2], the impact has been meaningful on the Utility Index[3] and its constituents. Utilities are not known for being major growth stocks. People generally own them for fairly steady dividends and a small amount of capital appreciation. It is noteworthy therefore that in the twelve months ended June 30, 2016, the Dow Jones Utility Average Index appreciated 30.2%. That twelve month capital appreciation almost matched the capital appreciation of the Dow Jones Utility Average Index for the previous ***fourteen and a half years.***

No secular or technological change has changed utilities' vector for the better. If anything, utilities in many places are under threat from energy efficiency and alternative energy initiatives. Therefore, we believe we are safe in assuming that the dramatic rise in many utilities' shares is due to a "bond equivalent" status among many investors in this low rate environment. That is to say stocks that typically exhibit lower growth and higher dividends, such as utilities, might be viewed by some investors as bond like. As we mentioned in our second quarter report, we caution strongly against viewing any stock as similar to a bond.

Ironically, there are other entities created almost exclusively for their yield that investors have thrown out over the past 12 to 18 months. One such example that has suffered is the Business Development Company (BDC). BDC managers either underwrite or participate in syndicates of loans usually made to small or medium-sized companies that cannot be served by large banks and cannot access the bond market.

BDC's come in all shapes and sizes and with managers of different tenure. Regardless of these differences, BDC's are designed to attract investors for their income rather than their capital appreciation potential and their typical diversification from stocks and bonds. In other words, they are what investors typically have looked for in utilities except in the cases of BDC, the S&P BDC Index[4] was down during the twelve months between June 30, 2015 and June 30, 2016.

---

[1] S&P 500 Dividend Aristocrats measure the performance S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The Index treats each constituent as a distinct investment opportunity without regard to its size by equally weighting each company.
[2] Available on www.ccmalternativeincome.com
[3] The Dow Jones Utility Index
[4] The S&P BDC Index is designed to track leading business development companies that trade on major U.S. exchanges. It is a modified market capitalization weighted index.

We will contrast a large utility company and a large BDC below. As before, all names are withheld for now to prevent any incoming bias, but will be named later. Here is a quick table as an introduction:

	Company A	Company B
Credit Rating (S&P)[5]	BBB+ (Negative)	AA (Stable)
Market Cap	$50 bln	$4.9 bln
Free Cash Flow Yield (TTM)[6]	-3.9%	10.5%
Dividend Yield	4.4%	9.58%
Dividend Payout Ratio[7]	72%	97%

Source: Bloomberg (as of September 9, 2016)

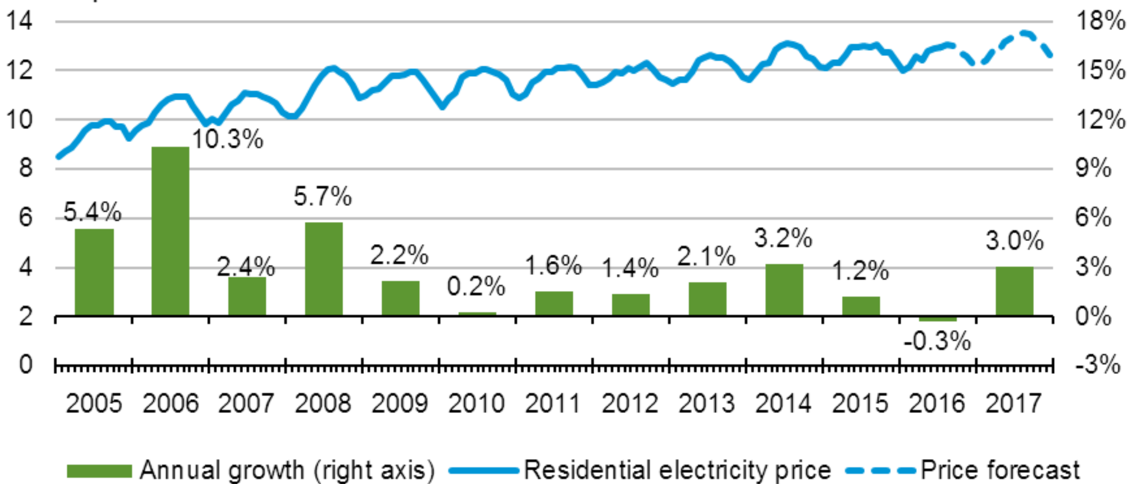
Company A

Company A is one of the largest utilities in the country, serving as the primary regulated electric and natural gas provider in several southern states. Regulated utilities can be odd beasts. They are allowed to petition regulators for rate increases to pay for their growth investments. In many such structures, like Company A, this creates incentives to spend on new capacity but *not* invest in efficiency since the more they generate, the more they get paid.

This structure and constant growth investing is why Company A has burned free cash ***before*** its dividend in 8 of the past 10 years[8]. This structure also leaves Company A vulnerable to secular energy efficiency developments. It invests assuming increased demand. Instead, due to energy innovation from LED bulbs to high efficiency air conditioners to solar panels, the growth of residential electricity demand has been muted in the past few years with 2016 projected to show a *decline*.[9] The green bars shown in the adjacent table illustrate this point.

---

[5] Ratings are on a scale from AAA(best) to D (lowest)
[6] "Free Cash Flow" is defined as (Operating cash flow – capital expenditure +/- working capital) and TTM stands for "Trailing Twelve Months".
[7] Defined as current dividends as a percentage of earnings per share, TTM basis.
[8] Using the company's publicly filed annual reports.
[9] Source U.S. Energy Information Administration http://wnew.www.eia.gov/forecasts/steo/report/electricity.cfm



Company A is not immune to these factors. In its second quarter 2016 public earnings, it reported weather adjusted electricity demand declines of 1.4% following the first quarter's demand growth of 0.4%. These numbers compare to the company's average annual growth from 2010 to 2015 of 0.6%.[10]

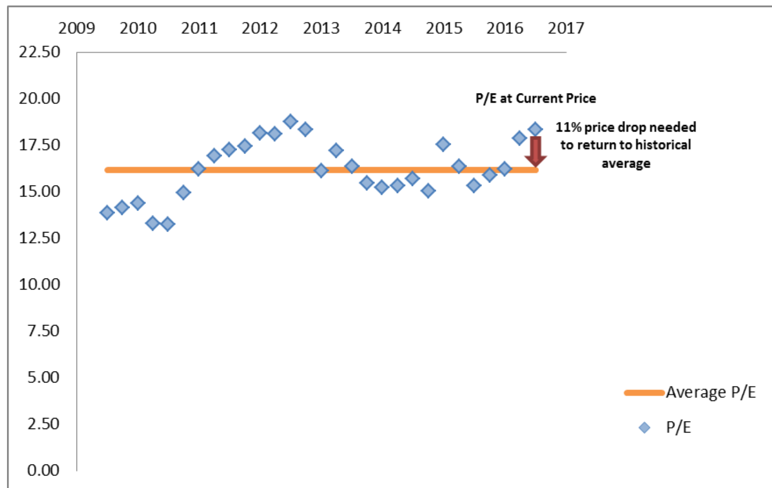
Dividend Sustainability

One would never know from Company A's dividend that its main business is slowing down. The company grew its dividend this year as it has since 2002. We find this dividend growth noteworthy as we had mentioned the company has regularly burned cash before it paid its north of $2.1billion of dividends. It is also noteworthy that as of the end of the second quarter 2016, the Company has spent over $8 billion on acquisitions in what seems like an effort to diversify away from its stagnant/declining core electricity franchise.

Share Price Sustainability

As a large component of many utility indices, Company A has participated in the general enthusiasm for utility shares regardless of underlying fundamentals. The company's stock appreciated 28% from June 30, 2015 to June 30, 2016. Company A is modest compared to its industry in that price appreciation over the last 12 months is only equal to roughly ***ten years*** of previous gains instead of over ***fourteen***. It is also slightly better valuation wise. Its current multiple of just over 18x earnings is only about 10% above its 10 year mean of 16.3x. However, it is also worth noting that Company A is part of a group of utilities that are highly exposed to energy efficiency headwinds, so perhaps it should be trading at a lower multiple than others.

[10] Using the company's publicly available annual reports.



2016 is based on estimated earnings Source: Bloomberg as of June 30, 2016.
Average P/E is for the period from 2009 through June 30, 2016.
P/E is based on share price at the end of Q2 divided by that that previous year's earnings per share.

Company B

Company B is a business development company or a BDC. BDCs are specialized lenders filling an expanding void created by recent regulatory restrictions embedded in Dodd Frank, which can limit bank's ability to lend to lower quality borrowers. Unlike banks, BDCs typically utilize less leverage, have permanent capital and there is more transparency of its assets since their loan portfolios (borrower, size and loan value) are generally listed in their public filings.

Company B is one of the largest BDCs. Its size allows it to have a larger and more diversified book of loans relative to its smaller competitors. The management team has generated a 13% IRR (Internal Rate of Return) since 2004.[11] The regulatory changes, in addition to the 13% IRR track record and size should act as a tailwind enabling it to grow organically and via acquisition in the years to come. Moreover, unlike Company A, secular changes appear to be working in BDCs' favor.

Dividend Sustainability

Because they are regulated investment companies, BDCs are forced to pay out a high percentage of their earnings with Company B's dividend yield at quarter end over 10%. In determining Company B's dividend sustainability it is vital to not only analyze its current loan portfolio, but to gain comfort with the manager's underwriting history. Many BDCs recently had to cut their dividends because of losses in the portfolio mainly in the energy sector. Fortunately, Company B's portfolio has held up well --as it did during the credit crisis -- and maintained the same dividend since 2012.

[11] Data as of Dec 31, 2015 from Ares Capital Corp slide presentation dated March 2016. Slide 11. IRR is a measure of total annual return over a period of time.

Share Price Sustainability

Dividend cuts and credit quality concerns at other BDCs have led to share price declines across the industry, Company B included. This development has allowed us to invest in Company B at a 20% discount to book value. This discount compares with a book value *premium* that Company B has averaged over the past 10 years and was trading at in June 2015. Given our analysis of the portfolio and the manager's underwriting history, we felt a 20% discount was implying far too many potential losses. Even with a broader high yield recovery and with recent gains in the stock this summer, we believe the stock is still at decent discount to book value.

Source: Bloomberg as of June 30, 2016. Average P/B is for the period from 2009 through June 30, 2016. P/B is based on share price at the end of Q2 divided by that that periods accounting book value.

Looking Forward

Company A is Southern Company. As with both Exxon and Sysco in our previous comparative pieces, we do not think Southern Company is a bad company. In fact, population growth in Georgia, Southern's largest market, can help mitigate some of the secular effects hurting its revenue. But the company's overall growth trajectory should still remain challenged. That dynamic would imply the company should be trading at a *discount* to the multiple it traded at before LED bulbs and other efficiency initiatives were less pervasive instead of a *premium*. If anything, we expect their uptake rate to increase as prices come down and more consumers take advantage to lower their utility bills.

Company B is Ares Capital Corp (ARCC). The understanding of Ares fits nicely within our skill set. The Badge managers spent many years investing in the exact types of credits that comprise the Ares portfolio. That experience, Ares's well-disclosed portfolio, its current discount and generous yield enable us to invest in the company with nice measure of comfort.

Conclusion

We have no idea if or when interest rates will rise and we are not trying to predict that. We believe, however, that investments should not be made solely on macro factors. Too many inherent risks are assumed predicated on the unknowable. While we understand the predicament many investors face in the current interest rate environment and sympathize with it, we hope we have elucidated some of the risks (and opportunities) that have been created by recent capital flows. As always we encourage investors to do their own work. We are available any time for questions or concerns investors might have and encourage all dialogue.

As of 6/30/16, Ares Capital Corp (ARCC) represented 0.03% of the Fund's net assets, Exxon represented -2.09% of fund's net assets, Sysco represented -1.19% of fund's net assets, and Southern Company represented -0.02% of the Fund's net assets. Holdings are subject to change. With short sales, you risk paying more for a security than you receive from its sale. Short sales losses are potentially unlimited and the expenses involved with the shorting strategy may negatively impact the performance of the Fund. There is no guarantee these holdings will have the intended effect on the Fund's performance.

The CCM Alternative Income Fund is distributed by SEI Investments Distribution Co. (SIDCO), 1 Freedom Valley Dr., Oaks, PA, which is not affiliated with Community Capital Management, Inc. or Badge Investment Partners.

These are the views and opinions of Community Capital Management, Inc. and Badge Investment Partners. Because market and economic conditions are often subject to rapid change, the analysis and opinions provided may change without notice. The analysis and opinions may not be relied upon as investment advice. References to particular securities are only for the limited purpose of illustrating general market or economic conditions, and are not recommendations to buy or sell a security. Statements of fact are from sources considered reliable, but no representation or warranty is made as to their completeness or accuracy. Although historical data is no guarantee of future results, these insights may help you understand our investment management philosophy.

Carefully consider the Fund's investment objectives, risks, and charges and expenses. This and other information can be found in the Fund's prospectus which can be obtained by calling 866-202-3573 or by visiting www.ccmalternativeincome.com. Please read the prospectus carefully before investing.