From:	Reid Hyde
To:	Chris Kirkpatrick
Subject:	udfi...sorry for delay...work email update?
Date:	Friday, March 29, 2019 10:22:33 AM
Attachments:	Value Investors Club - UNITED DEV FUNDING IV (UDFI).pdf Untitled attachment 00009.html

UNITED DEV FUNDING IV UDFI

March 20, 2019 2:26pm EST
by RoyalDutch

			2019	2020
Price:	4.08	EPS	0	0
Shares Out. (in M):	31	P/E	0	0
Market Cap (in $M):	125	P/FCF	0	0
Net Debt (in $M):	8	EBIT	0	0
TEV ($):	0	TEV/EBIT	0	0

Description

Thesis

United Development Funding IV ("UDF IV") is a long at current levels ($4.09) because the intrinsic value is with high probability greater than current levels with a near term catalyst, being the publication of restated accounts that will make the undervaluation apparent.

United Development Funding

UDF IV is part of a family of funds (together "UDF") that provide financing to residential housing, construction and development projects primarily in Texas. UDF IV was the 4th fund in the succession and was the only one that was listed on the NASDAQ as a REIT, whilst the other funds are public non-traded REITs.

Kyle Bass' Short Attack

In 2015 Kyle Bass (Hayman Capital, of "Big Short" fame) launched an aggressive short attack campaign on the UDF funds, whilst taking a large short position in UDF IV. After spreading posts anonymously (via www.hvst.com) starting in 2015, a website was set up (www.udfexposed.com), through which claims were reiterated and expanded upon throughout 2016. The information was also spread to UDF's business partners, lenders, borrowers and accountants. The first anonymous post appeared on VIC on 10 December 2015, concurrent with the launch date of the campaign. In summary, the short thesis amounted to the following:

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1. The UDF funds exhibit "Ponzi-like" characteristics:

   "The UDF umbrella exhibits characteristics emblematic of a Ponzi scheme: (1) new capital, both equity and debt, is used to fund distributions to existing investors; (2) subsequent UDF companies provide significant liquidity to earlier vintage UDF companies, allowing them to pay earlier investors; and (3) if the funding mechanism funneling retail capital to the latest UDF company is halted, the earlier UDF companies do not appear to be capable of standing alone and the entire structure will likely unravel, with investors left holding the bag."

2. The largest group of borrower entities to the UDF funds, Centurion, may be in financial stress, is not an arm's length borrower to UDF and a participant in the "scheme".

Kyle Bass leveraged the contacts of his general counsel, Christopher Kirkpatrick to approach the SEC (his former employer) and the FBI, present the short thesis and encourage them to instigate actions against UDF. On 18 February 2016 the FBI raided UDF's offices. UDF IV fell behind on filings after its auditor resigned (without disagreements a per the 8-K) and Kyle Bass hired a law firm to argue against further extensions of filing deadlines by sending a letter to NASDAQ. On 18 October 2016, UDF IV received a delisting notice from the NASDAQ and through an 8-K it also disclosed simultaneously it was in receipt of a Wells Notice from the SEC.

Kyle Bass closed out his short position between 19 - 27 October 2016 and has stopped posting new material since. UDF IV dropped from $17.5 to a low of $1.75, which is a market cap erosion of ca. $470m.

The Basis of a Variant View

There are 2 important events that give rise to a variant view:

1) UDF IV has been *repaying its debt* down from $170.9 to $7.5m, per 5 August 2017, as per 8-K filings.

2) On 28 June 2018, the SEC filed a complaint against UDF, which is immediately settled *without*

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UDF admitting or denying the allegations, subject to a monetary fine of $8.3m, resolving the investigation.

Firstly, being able to repay debt means that the assets are worth something, unlike an outright fraud where money would have disappeared in worthless assets. Secondly, settling with the SEC without admitting to wrongdoing and being able to carry on business as usual, implies more of a “slap on the wrist” rather than the occurrence of material irregularities, especially given the length of the investigation (4 years) and the FBI raid. Lastly, an investigation by an external law firm commissioned by the independent trustees, concluded after 4 months that there was no evidence of fraud or misconduct by UDF IV.

The Allegations from the SEC

The complaint filed by the SEC contains the allegations against UDF that *would have been pursued* if UDF had not settled with the SEC (the filing of the complaint was part of the settlement). The allegations amount in summary to the following:

1. *“In 2011, UDF IV began loaning money to developers of UDF IV projects who had also borrowed money from UDF III. Unbeknownst to investors, however,* ***UDF directed the developers to use the UDF IV money to pay down separate UDF III loans****, instead of using the funds loaned from UDF IV to develop UDF IV project.”[...] “Using these transactions, which were not adequately disclosed to investors, UDF was able to cause UDF III to pay its investors* ***at least $67 million*** *of distributions using funds from UDF IV.”*

2. *“UDF IV also* ***failed to adequately disclose the nature of multi-phase projects*** *in its loan portfolio. UDF IV told investors that none of its loans were invested in unimproved real property. This gave the impression that all of the loans in UDF IV’s portfolio were funding real estate projects that were under construction. In truth, UDF IV had loaned money for acquisition of unimproved properties designated for multi-phase development. In some cases, the properties remained in the entitlement phase even after they had been in UDF IV’s portfolio for years.”*

3. *“****UDF III*** *knew or should have known before it filed its 2013 Form 10-K that it was* ***unlikely to fully collect*** *on an approximately $80 million loan to its second largest borrower.”*

UDF Files Lawsuit against Kyle Bass

On 28 November 2017, UDF filed a lawsuit against Kyle Bass and his funds for "*business disparagement, interference with contract, interference with prospective economic advantage and civil conspiracy*". The discovery was initially limited as Kyle Bass filed a motion to dismiss under the TCPA, arguing that he was exercising rights of free speech and that the speech was made without actual malice. The motion was subsequently ruled in favour of UDF and full discovery then continued. Kyle Bass is currently appealing against the decision.

The affidavits and the discovery materials provide the inputs to a sum of the parts analysis of intrinsic value.

Discussion of the Kyle Bass and SEC Allegations

"Ponzi-like" scheme vs aggressive dividend smoothing

Kyle Bass was right to point out that UDF IV funds were used to defacto pay distributions from other UDF funds. The underlying cause of this, however, was not because cash was being misappropriated (as strongly suggested by Kyle Bass) but seems to have been due to normal lumpy cash realisations inherent to the real estate business and the ultimate occurrence of the Buffington default in UDF III (more below). In lieu of these payments to other funds UDF IV grew a "related party" asset balance.

The investor base of UDF (mostly retail) had to be kept happy and monthly dividends had to be paid, even though not covered by actual cash earnings. The non-payment of a dividend would have clearly harmed the UDF franchise and from experience we know it's a common incentive for BDCs, MLPs and REITS to "extend and pretend" the payment of dividends for as long as they can.

It seems UDF was at least aggressive, if not wrong, in pursuing this course of action even though they ultimately got away with not admitting (nor denying) this claim as filed by the SEC. For the SOTP analysis further below this is reflected by adjusting all related parties assets down by 50% even though we see no reason why the UDF IV claims to other funds should not be money good, given that they are collateralised, however one can question the arm's length nature of these transactions and hence the

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substantial discount applied seems justified.

Centurion: legitimate and money good

Centurion was also attacked by Kyle Bass and implicated into the alleged scheme. The SEC said in their complaint that the concentration risk was not “adequately” disclosed (p.39 of the Q3 2015 10-Q gives a good hint though). Given that 67% of the UDF IV outstanding loan balance at Q3 2015 was linked to Centurion it seems crucial to understand how Centurion’s performance has been through the short campaign and thereafter.

We refer to the affidavit of Mehrdad Moayedi (CEO of Centurion):

â— Centurion is a seasoned developer in Texas, has been involved in high profile projects and has been favourably profiled in various media (§4-5), this can be easily independently verified via public materials;

â— Centurion was forced to sell projects after the short attack to DR Horton as it was concerned that UDF IV would not be able to provide further funding, these projects became successful thereafter (§12);

â— Centurion’s loan balance with UDF steadily decreased since the short attack (§14).

Furthermore, from §266 of the affidavit of Hollis Greenlaw (CEO of UDF) we learn that Centurion had to sell assets to repay USD 167m of debt to due to UDF funds.

We have performed searches on known Centurion borrowing entities and none of them showed any bankruptcy filing. Crucially, UDF IR confirmed to us that UDF loans are “mostly” cross defaulted against other loans from the underlying developers, so if Centurion had defaulted on any UDF debt, it would have most likely triggered the acceleration of a significant amount of debt at UDF IV and hence resulted in the filing of an 8-K (as what happened with the Buffington loan write down at UDF I & III, see below). In summary we can’t find anywhere that Centurion failed to pay on any debt due, even though they were indirectly adversely affected by the liquidity crunch at UDF.

Based on the above and other data points we take the view that Centurion is a legitimate business and it's past loans are money good at this point in time.

Multi-phase projects

Separately, the SEC has alleged in their complaint that the multi-phase nature of the loans was not adequately disclosed and that some loans stay in the entitlement phase for years.

Through our research we conclude that the nature of the underlying business requires that some loans do have to stay on accrual for prolonged period of time, however, this does not mean that these loans are automatically impaired, or that the borrowers are insolvent. UDF would basically extend the loans in (with interest added to the principal balance) cases where the entitlement phase would take longer than expected, subject to additional underwriting. This is standard practice for real estate development projects and when entitlements are granted or upgrades like roads are realised the value of the underlying collateral will tend to increase as well which then provides additional security to the increased loan balance.

Of all assets listed in the latest Q3 2015 10-Q, roughly 18% would fall into this category, where 84% of that 18% has Centurion as a borrower, which as concluded above is an established and creditworthy borrower, which we do not expect either to "selectively default" on these assets, due to the value of the underlying projects, the potential cross default language and wider reputational deterrents.

From the same 10-Q we also observe 3 types of collateral that serving as primary collateral could be regarded as weaker forms:

1) Pledge of equity interests in the borrower or borrower affiliate 5% of the portfolio
2) Reimbursements of development costs 4%
3) Unsecured 3%

In the SOTP analysis below we adjust the outstanding principal of loans and also the interest already received (due the extensions where interest gets added to the principal balance) downwards by 30% to reflect any concerns related to these assets.

Buffington

The SEC alleges that a USD 80m loan should have been impaired earlier and refers to the borrower as the “Austin Borrower”. This borrower is in fact the developer Buffington Land Development LLC (“Buffington”). The affidavit of Joe Straub, a partner of developer Harris & Straub LLC (a borrower of UDF and a party interested in acquiring the Buffington assets, “Straub”), provides a good overview of what has happened here.

Buffington seems to have fallen behind on its loans at some point after 2014. At the same time, UDF was looking to restructure the Buffington loans by amalgamating the assets and loans (without impairment) with existing Straub loans with the promise to fund further development on those properties. A letter of intent was agreed shortly before the short attack but the restructuring was never executed as Straub became (rightly) concerned that the short attack would dry up liquidity at UDF so that further funding would not be available.

According to §269 of the affidavit of Hollis Greenlaw the UDF IV outstanding loan balance to Buffington was USD 68m. After the Straub restructuring fell through no other developers were willing to take on the properties (ibid. §276). The portfolio was then substantially liquidated for USD 40m (ibid. §277). Based on the termsheet in the affidavit of Joe Straub (Annex 1) one can see that only UDF IV had secured debt whilst the other UDF entities were junior. Hence the implication here is that UDF IV lost $68-40m = $28m, with the debt at the other UDF entities fully written down (as disclosed via 8-K). We apply this as an immediate write down in our SOTP analysis below.

Sum of the Parts

Based on certain assumptions (see appendix) we roll forward the existing loan book and apply all known other cash receipts and payments. The resulting principal and interest balance and net cash are then fed into a sum of the parts, which are then further risked adjusted to get an intrinsic value as per the discussion above. The resulting intrinsic value per share is ca. $10.

It’s interesting to note that net cash generated was negative in 2016. This corroborates with forbearance agreements being entered into during that year (in respect of one note, as disclosed via 8-Ks) and §233 of the affidavit of Hollis Greenlaw, that mentions that cash sweeps went up to 100% to pay down debt due to the attacks. Apart from banks not extending lines anymore, the actual legal trigger in our view

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would have been the non-filing of accounts, which is a standard event of default for bank loans. UDF IV has continued doing business, but as per §265 of the affidavit of Hollis Greenlaw the amounts have been relatively small and hence we ignore that for simplicity.

Loan Balances	30-Sep-15	IMPAIR	30-Sep-15	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Accrued interest receivable	29.8	0.0	29.8	25.3	24.0	18.9	15.0
Accrued interest receivable - related parties	6.2	-3.1	3.1	4.0	3.8	3.0	2.4
Loan participation interest - related parties, net	35.3	-17.6	17.6	16.7	13.2	10.4	8.2
Notes receivables, net	513.2	-28.0	485.2	459.7	363.2	286.9	226.7
Notes receivables - related parties, net	69.6	-34.8	34.8	33.0	26.1	20.6	16.3
Principal and interest balance	**654.1**	**-83.6**	**570.5**	**538.7**	**430.2**	**339.8**	**268.5**

Flows	Q3 2015	FY 2016	FY 2017	FY 2018
Principal receipts	28.2	107.0	84.5	66.8
Interest receipts	23.8	65.2	56.1	44.3
Interest expense	-2.5	-10.0	-1.0	-1.0
Operating expenses	-7.5	-30.0	-25.0	-20.0
Dividends paid	-14.3	-6.6		
Debt repayments		-144.0	-19.4	
Cash generated per year	**27.8**	**-18.5**	**95.2**	**90.1**

Total period principal receipts	286.5
Total period interest receipts	189.5
Total period cash outgoings	-281.3
Total net cash generated for period minus total interest receipts	**194.6**

Sum of the Parts		Unrisked	Factor	Risked
Assets + Receipts				
Cash at Q3 2015		19.0	100%	19.0
Total period principal receipts		286.5	100%	286.5
Total period interest receipts		189.5	70%	132.6
End of period principal and interest balance		268.5	70%	187.9
Liabilities + Outgoings				
Total period cash outgoings		-281.3	100%	-281.3
Remaining debt - as per 8-K		-7.5	100%	-7.5
Known costs disclosed in lawsuit v Kyle Bass		-1.7	100%	-1.7
SEC settlement costs		-8.1	100%	-8.1
Class action settlement costs current and contingent		-8.9	100%	-8.9
Cost of lawsuits ongoing and contingent		-10.0	100%	-10.0
Total NAV		**445.9**		**308.5**
Shares outstanding (m) Q3 2015	30.672			
NAV Per share		**14.5**		**10.1**

Sum of the Parts Analysis, in $millions

Discussion of Other Risks or Upside to the Thesis

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â— Unknown impairments or losses due to forced asset sales

  â—‹ Centurion is the biggest borrower at UDF IV, if they are money good (as argued earlier) then the rest is immaterial from a downside perspective to the current stock price.

  â—‹ There are no other 8-Ks with debt forgiveness announced except for the Buffington debt forgiveness at UDF I & III.

  â—‹ Apart from the Buffington "forced" liquidation there is no other mention in the lawsuit documents against Kyle Bass of losses suffered due to forced sales; which you would expect to disclose if you are suing for damages.

â— House prices in Texas

  â—‹ It seems that house prices are starting to soften in the Texas area.

  â—‹ However, this is after median house prices in the area representative of the UDF IV portfolio have increased by 18.5% since Q3 2015 until today.

  â—‹ Overall we conclude the underlying collateral of the UDF IV loans has strengthened materially in the interim and thus lowering the overall credit risk of the portfolio

â— Upside from lawsuit against Kyle Bass

  â—‹ We think the merits of the case are strong but it will be difficult to ultimately go against First Amendment rights, even though it's likely a Texas jury trial will come out in favour of UDF initially.

  â—‹ If UDF wins the case that the damages payable by Kyle Bass could be significant.

Near Term Catalyst

The main problem with the long thesis has been the delay of the publication of accounts since Q3 2015. Due to the continued delinquency in periodic filings the SEC issued administrative proceedings against UDF on 24 September 2018. The response from UDF explained that, after the new auditor (EisnerAmper) was appointed, it decided not to continue the audit until the SEC settlement, subject to not barring any officers or directors. This only happened on 18 June 2018. Since then work has been progressed and UDF expects to file omnibus 10-K statements for 2017 and prior periods on or before 31 March 2019.

Conclusion

Through an aggressive short campaign Kyle Bass managed to bring down UDF IV stock from USD 17.5 to a low of USD 1.75, reaping profits on a large short position. It also seems to have led to a liquidity crunch at the UDF funds which had the consequence of significant deleveraging and a shrinkage of their business. Whilst UDF can arguably be blamed for transferring assets between funds to smooth dividends (say even on an arm's length basis), any "ponzi-like" allegations from Kyle Bass seem to have been without merit. If we adjust for any risk concerns raised by our analysis we find it likely that the UDF IV trades at a significant discount to intrinsic value.

Risks

â— Centurion defaults leading to a liquidation of the portfolio.

â— House prices soften in Texas leading impairment of collateral underlying loans.

â— Potential suspension if no accounts are published by the end of March 2019 (although it's more likely that shares will continue to trade in the grey market).

â— Even though we see a large discount to intrinsic value, some discount might still be justified as trust in management and the business model can not be expected to be restored fully in the short term.

Appendix: Underlying SOTP Assumptions

â— We apply certain impairments to the Q3 2015 numbers from the outset:

  â—‹ All related parties assets are written down by 50%, as discussed

  â—‹ The third party notes receivables are written down by $28m, due to the Buffington write downs (8-K of 6 January 2017 & §277 of the affidavit of Hollis Greenlaw)

â— We historically analyse principal receipts per year as a % of the principal balance per previous year. Historically this has been 34%. We assume that this number is 21% as derived per §262 of the affidavit of Hollis Greenlaw. Please note that some loans have a right to extend - which would corroborate this lower number given the circumstances.

â— We assume that the accrued interest receivables of the previous year get fully paid and we then determine the following accrued interest balance based on a historical ratio over the last 5 years.

â— The interest rate expense for Q4 2015 is a proration based on the first 9 months of 2015. FY 2016 is punished because UDF IV found itself in a 100% cash sweep, forced to pay down debt. FY 2017 and 2018 are at a de minimis level given that debt has been largely repaid.

â— The peak operating expense occurred in 2014 at ca. $30m. We pro-rate this for 2015 and 2016 and decrease with $5m per year for FY17 and FY18 given that activity levels would have dropped, but assuming still elevated levels given the ongoing investigations.

â— We assume a $10m cost of current and contingent lawsuits on top of the class action lawsuit that have already settled.

I do not hold a position with the issuer such as employment, directorship, or consultancy.
I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

Publication of accounts

Messages

No messages