Mercantile Notes

Mercantile has just announced the launch of a new income offer: Mercantile Notes. Access is available through a broker firm allocation, shareholder and general offer, prior to listing later this month.

The Notes will pay a half yearly coupon at 8%pa and are due to mature 7th June 2021. The Notes will be tradable on the ASX.

Mercantile Notes Offer Details	
Issuer	Mercantile Investment Company Limited
Security Name	Mercantile Unsecured Notes – (MVTHA)
Maturity Date	7th June 2021 (unless redeemed earlier)
Interest Rate	8% pa (semi annual distributions)
Size	$15 Million
Minimum Parcel	$5,000 (Wealth Focus minimum is $10,000)

Source: Mercantile Investment Company Notes prospectus

This issue will be used primarily to expand the underlying portfolio and repay existing short term debt.

Mercantile Investment Company

For those unfamiliar with the Mercantile, they are a listed investment company headed by veteran corporate raider, and famous activist investor, Sir Ron Brierley. Mercantile manage in excess of $45 Million with the majority of the fund investing in small caps and listed property trusts.

This raising will be used to expand the underlying portfolio and repay the short term debt facility.

The issue is relatively straightforward, a fixed term note, repayable in 5 years with an 8%pa fixed rate coupon.

The key concern for investors should always be the ability for management to service such a high rate of return since the security is the underlying value of their portfolio. Ron Brierley and the Weiss family reputations for investment are clearly a reassuring factor, and the current board have clearly demonstrated their ability to manage money, having provided a compounded return of 23.8%pa (30/04/16) since they took control of Mercantile in early 2012. Furthermore, unlike most hybrid offerings that rely on one company and exposed to a single sector, the underlying return on capital is derived from a diversified portfolio of underlying investments, reducing investment risk.

Key features

- **High fixed rate of return** – 8%pa semi-annual distributions
- **Fixed term of 5 years -** Mercantile has the option to convert/redeem at any time.
- **Non-payment of distributions is a default event**

What we like

- Relatively simple structure. Assuming solvency, the Notes have to be paid back in 5 years
- Diversified portfolio of underlying investments
- Management have demonstrated their ability to successfully manage a portfolio of investments
- Relative to cash rates, a high income level of 8%pa
- Non payment of Interest is a Default event
- A fixed rate of return which is likely to become more attractive as interest rates fall
- Distributions are unfranked (*Read our article on when unfranked is better than franked*)

Concerns

- The underlying portfolio has a small cap bias.
- Just over a third of the portfolio is currently invested in one stock, Ingenia Communities Group, and arguably dwarfs the remaining portfolio
- A small offering of $15 Million means it is likely to be relatively illiquid
- If the raise is increased to $25 Million, we have some concerns over the level of gearing
- The company can issue further debt, ranking equally or senior to Note holders without prior consent
- There are no-debt covenants to protect investors from management increasing debt levels
- There is no mandatory Change of Control should the company be taken over (it remains at the board's discretion).

Our view

This is a relatively simple structure that allows investors to focus on the key investment risks of the underlying portfolio versus overall debt. Unlike the bank hybrids that are currently yielding close to 7%pa, late distributions and repayment (in 5 years) are default events, and the underlying exposure is across a diversified range of companies.

We view the key risk as mismanagement of the underlying investments but with such a strong investment team, this is less of a concern.

Overall, this looks to be priced well for investors and offers better value than the recent Peet Bonds issue. Our concerns are primarily the heavy weighting to one underlying investment, the ability to issue more debt, and lack of debt covenants. However, at 8%pa, we feel investors are being adequately rewarded for this risk.

Note: Mercantile Notes will be listed on the ASX and as such the price of the Notes will be subject to market movements. Investor's selling on market may receive a price lower (or higher) than the issue price.