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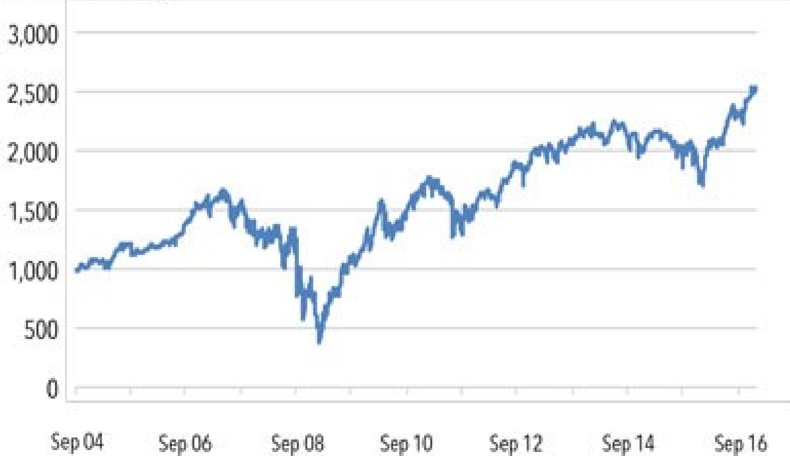


# Liquid debt strategies: Learning your BDCs

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*Complexity and volatility mean institutional investors tread carefully when it comes to business development companies. But improving performance and favourable legislation may force them to think again.*

For investors who looked to business development companies as a liquid alternative to more locked-up ways to play the private debt field, recent performance has provided support for the choice.

BDC stock prices have steadily climbed in recent months, pushing values in early 2017 to around 52-week highs. The Cliffwater BDC index, which tracks the sector, shows US BDCs gaining more than 40 percent from 8 February, 2016, to 7 February, 2017.

In a 2016 year-end commentary, Cliffwater noted that BDCs performed better than US leveraged loans or high-yield bonds. The trend continued into 2017, with BDCs in the Cliffwater index posting 9.41 percent yield through the first week of January 2017, compared with 5.25 percent for US high-yield bonds.

“They have had a very big run over the last year,” says Ryan Lynch, a research analyst at Keefe, Bruyette & Woods who specialises in BDCs. “What the market is saying to these BDCs is, ‘You have generated good returns, so your stock price is up.’”

Not all BDCs are sharing in the good fortune. Fifth Street Financial saw its stock price drop sharply on 9 February after the company reported a loss and investors were less than wowed by its plan to restructure fees and dividends.

But for better performing BDCs, the market rewards have been significant. One of Lynch’s favourites is Ares Capital, which completed its merger with American Capital in January to form the largest BDC with assets of $12.3 billion. Ares gained about 10 percent in value from December to mid-February. Another Lynch favourite is Hercules Capital, which rose about 9 percent for the same period.

BDCs have been helped by a recovery in energy prices. Many had heavy exposure to the energy sector and were hit hard when oil and gas prices fell. Another factor helping boost stock prices was the general market rally along with improvement in the financial sector.

Yet despite recent positive signs, BDCs remain a hard sell for many institutional investors, which are wary of volatility. BDCs jumped 50 percent in value from 2004 to 2007, per the Cliffwater index, then lost more than two-thirds of their value in the financial collapse. But after banks retreated from leveraged lending, BDCs came roaring back as a key lender to mid-market companies and regained all the lost value by 2010. BDCs then rose and dipped a few more times before starting their run up last year.

Indeed, for institutional investors turned off by BDCs, less liquid alternatives like high-yield and other private debt options have proved more stable and attractive, and often less expensive when it comes to fees. It may not be as easy to exit these long-term investments, but principle isn’t subject to market fluctuations like BDCs.

In addition, liquidity can vary depending on how actively traded a BDC is. Some smaller BDCs trade infrequently and at low volume, which can make exits problematic. Larger BDCs like Ares are more liquid, regularly trading 1-5 million shares in a day.

The liquid alternative in private debt remains primarily a US phenomenon. BDCs generally exist to provide loans to mid-market companies, with many specialising in loans to private equity-sponsored companies. Ironically, many institutional investors that take stakes in private equity funds are reluctant to invest in BDCs. While institutional ownership levels vary among BDCs, the average continues to hover between 20-30 percent.

Neil Sheth, head of alternatives research for NEPC, which advises foundations, endowments and pension funds on allocations, says his firm has been behind the placement of $3 billion-$4 billion in client allocations to mid-market lending. But none of that went to BDCs.

One problem he sees is that investors tend to view BDCs as a debt or fixed-income investment, but the returns are often influenced by trading in the company’s equity. A nice yield can be undercut by a declining stock price. And BDC equity prices can be volatile.

Another issue is fees. BDC fees have been comparable to charges levied by hedge funds or private equity

funds. BDCs were charging ‘2 and 20’ until recently, when management fees began being scaled back to around 1.75 percent.

“One of the main reasons we have not [invested with BDCs] is because of the fees,” Sheth says. “The question is, ‘Why would you pay anybody 2 and 20 to do this?’”

Cliffwater, which also advises institutional investors, has been more open to BDCs, investing with eight to 12. One of the main attractions, says the firm’s CEO Stephen Nesbitt, is BDC yields, which have handily outpaced high-yield bonds and leveraged loans. “Those yields are depressed, so investors are looking elsewhere,” he says.

One of the problems for institutional investors is figuring out how to treat BDC investments. While BDCs are in the business of making mid-market loans, they are public companies so are essentially dividend-paying equity investments.

Christopher Acito, founder and CEO of Gapstow Capital Partners, an alternative investment advisor, says the equity aspect of BDCs can also point to a different way of gaining exposure to private debt. US community banks are primarily small business lenders, Acito says, and as such their stock offers another avenue for getting into US private debt.

Community banks tend to deal in lower loan amounts than BDCs and their operations are more closely supervised by banking regulations than BDCs. But to Acito, their heavy reliance on business lending as a source of income makes them similar to BDCs.

“We view community banks as relatively straightforward plays on credit,” Acito says. Many of those banks are publicly traded so investments in them can be viewed as similar to BDCs, he adds. Like BDCs, community banks were trading at a significant discount to NAV in the recent past and have since moved up.

Lynch says 2017 holds promise for BDCs. Interest rates have started edging up and that could provide a boost to rates charged. While President Donald Trump has talked about reforming US banking laws, there is no indication that banks will be returning to mid-market lending any time soon, Lynch says, so the possibility of new competition does not appear probable. Trump’s general pro-business outlook could be good for business expansion, which could increase the appetite for business loans. Meanwhile, legislation sought by BDCs to raise leverage limits could be viewed more favourably by the new regime in Washington.

“As we turn to 2017, I am hopeful we will see stronger fundamental returns for BDCs,” Lynch says. “We could have portfolio yield expansion from rising interest rates. We could have improving credit quality as a result of better energy prices and lower credit losses. A lot of BDCs reduced dividends in 2016, so most dividends are now more sustainable.”

If that scenario pans out, it could be an encouraging sign for institutional investors which have stayed on the sidelines, and their participation could be an added boost to BDCs.

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