DLDeals.com's Thompson Talks About The Pain – And Recovery – Ahead For BDCs

Friday, May 22, 2020

Chuck Jaffe, in The NAVigator podcast, interviewed Kelly Thompson, founder and editor at Direct Lending Deals. Read the Q & A below as Kelly says that business-development companies specializing in middle-market lending are facing the pain of some defaults and the potential for restructurings, but she believes that the problems ultimately will make for buying opportunities and better conditions for BDC managers. While waiting for those calmer, surer times, Thompson suggests sticking with older, more established BDCs, particularly those that rode out the financial crisis of 2008.

Kelly Thompson

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Kelly Thompson, founder and editor of Direct Lending Deals is here, and we're talking about the upcoming earning season and what it means for business-development companies now on The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. Kelly Thompson, my guest today, is the editor at Direct Lending Deals, and she is a journalist covering the leverage finance world, and she's been doing it for a good, long time. If you want to learn more about what Direct Lending Deals does, you need to go to DLDeals.com. You can follow Kelly on Twitter, she is @MMKtDoyenne. And by the way, the MMkt is for middle-market, and we're going to talk about middle-market and BDCs now. Kelly Thompson, thank you for joining me.

KELLY THOMPSON: Hi Chuck, thanks for having me. Great to be here.

CHUCK JAFFE: Before we jump in straight to the BDCs and earning season, we need to get a little bit of perspective from your point of view. Because you are, as I said, a journalist. You're the editor of Direct Lending Deals. Help my audience understand what Direct Lending Deals does, the part of the industry that you cover, and then how to that relates to BDCs, and brings us to all the things we're about to talk about.

KELLY THOMPSON: I founded Direct Lending Deals last September. It's basically a publication that covers middle-market and lower middle-market lending. It's all about credits, and most of our readers are in leverage finance; advisors, law firms, pretty much anyone that is involved in middle market finance. This is the audience that BDCs cater to, they are mandated to lend to middle market companies.

CHUCK JAFFE: A BDC, just to make sure everybody doesn't get caught up in the jargon, for some who are here and are new to closed-end funds, it's a form of unregistered closed-end investment company. So basically it's part of the closed-end space, and as you pointed out, middle markets, that's where it's going. So let's talk middle-market lending right now, depending on what the loans are about, the lending activity is kind of all a little bit crazy because of everything that's going on. One area where I would think it could get ugly is exactly the area that you look at.

KELLY THOMPSON: So middle-markets/direct lending is basically where a couple of lenders will underwrite an entire deal for a small to mid-sized business. This is different from the large syndicated lending world, where a large cap company like Airbnb will go to the market and they'll need a billion dollar loan, so that will get sold off to a bunch of different lenders. Direct lending is the exact opposite of that. It's like one or two or maybe three lenders at most that will underwrite a whole loan, and they'll book to hold. The space has grown in popularity immensely since the last credit crisis. And basically the thinking has gone, you can get 8-9% on these loans, as opposed to high-yield bond yields, which up until recently were around 5 or 6%. Direct lending loans are senior secured, so if something goes wrong, you're in a better place in the waterfalls if you would be for a high yield junk bonds, which is beneath loans. So in this situation, where companies have been operating now for two months or more without any revenue, every business is in trouble. But from a recovery standpoint, middle-market loans or direct lending loans should be in a better position. Investors should be in a better position recovery-wise if it comes down to that, when the business needs to be restructured, if it needs to be restructured.

CHUCK JAFFE: Will we wind up seeing BDCs get significantly hurt? If you wind up with non-performing loans, you have to assume you're going to take it on the chin in a couple of different ways. What's the expectation for pain? And what's should somebody who's investing in BDCs consider reasonable? I mean, how much of a decline are you willing to stomach? And I realize everyone has their own pain tolerance, but as somebody who analyzes these things, there's got to be a threshold where you go, "Wow, that's maybe a little more than we'd expect."

KELLY THOMPSON: So BDCs just got done reporting for the most part, and interestingly I was just looking at the non-accrual rate for all the public BDCs, and they did go up. No surprise there. On average, I think the non-accrual rates went up about 2% over the last quarter. I think that's definitely in line with expectations that were out there. However that does only take a look at the first quarter. So in the first quarter there were a few weeks where there were business shutdowns. The second quarter's going to be more telling. I would expect the non-accrual rate to go up again, but BDCs do have a couple of tools in their toolbox that they can use. For one thing, they can keep investments on their books and they can restructure. If they need to restructure senior debt, they can exchange that for equity and they can ride out the storm, and hope for a sale down the road. And then make the money back on the sale from their equity position on the restructured company. That would be the main thing. Is they can always restructure the businesses and hold onto them until they get sold or refinanced out at a better time. Also going forward, the terms that they're able to book loans will be much more attractive, so their rates will go up. Which is great, and that will support dividends. I do think second quarter, third quarter is going to be tough. Businesses are definitely going to be hurt, non-accruals will definitely go up. But I do think that large, more experienced managers that were around the last time the market crashed, will be able to navigate problem credits and be able to prop them up to get them through this rough patch. And hopefully that will be enough to get us through to next year. The market is going to be rough for everyone everywhere, and the next two quarters will be very telling. But beyond that, I do think that there will be some recovery, and I do think that BDCs have the tools to restructure deals and carry them through to at least where the market stabilizes.

CHUCK JAFFE: That being the case, for many folks who come to a show like this one, they have dipped their toes in, they've bought A, B, C, D, or what have you. Would this be a time where you want to make sure, if you're a BDC investor, that you have diversified, you're not all eggs in one basket on a BDC? But you kind of go, "Okay, if I want to be in the BDC space, let me pick a couple. Because right now the risk is a bit heightened, so spread my risk around within the sector."

KELLY THOMPSON: That's a good question. I think if you wanted to jump into a BDC right now, right now there's probably about 50 public BDCs that you could buy. I would take a look at the ones that were around before 2008, and the ones that came out of 2008 that are still around and that are still doing okay. And I would probably look at the ones that are bigger. The ones that are bigger are more diversified. They have more access to funding sources, and they have the management resources to hire restructuring firms, to hire the big attorneys, they have more tools that they can use to manage the portfolio in a time of a downturn like this. Those are the types of BDCs that I would look at.

CHUCK JAFFE: Kelly, great stuff. Thank you so much for joining me on The NAVigator.

KELLY THOMPSON: Thanks for having me, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I'm Chuck Jaffe, your host, and you can learn more about my work and my show at MoneyLifeShow.com. To learn more about closed-end funds and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're also on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Kelly Thompson, founder and editor of Direct Lending Deals. You can learn more about her site at DLDeals.com and follow her on Twitter @MMktDoyenne. The NAVigator podcast is available every Friday, please subscribe where you find all your favorite podcasts. We hope you'll join us again next week. Until then, stay safe everybody.

Recorded on May 21st, 2020

To request a particular topic for The NAVigator podcast please send an email to:

TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

Disclosure: *Listed closed-end funds and business development companies trade on exchanges at prices that may be above or bellow their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Nonlisted closed-end funds and business development companies do not offer investors daily lliqudity: often on a small percentage of share on a quarterly or semi-annual basis. CEFs often use leverage, which can increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.*