BDC Sessions

By Jennifer Banzaca

Following the lockdowns and onset of impacts of the coronavirus, when the stock markets went into turmoil, many business development companies (BDCs) took a step back to avoid the worst of the effects.
During three BDC tracks during the Active Investment Company Alliance (AICAlliance.org)'s Summer Summit on August 13th, panelists largely agreed that as volatility and valuations have fluctuated, some investments have become riskier, thereby causing some BDCs to shift their investment focus.

Michael Shekel, a Director of Valuation Advisory Services at Cherry Bekaert, noted during the BDCs From a Service Provider Perspective panel that larger BDCs tend to move away from riskier investments during times of market stress.

"Larger BDCs try to be more risk averse but that also creates more opportunities for smaller BDCs, so there is some benefit there." Shekel noted.

Kelly Thompson, Founder and Editor Direct Lending Deal, said the ongoing effects of the pandemic will cause an increase in non-accruals in the coming months.

"I would say generally across the board non-accruals are up, even for really experienced managers. And the big disparity you see is that BDCs with $4 billion in investments or more are weathering COVID much better than BDCs that are targeting lower middle market businesses. Some of those BDCs that are focused on the lower middle market have double digit non-accruals right now."

Nicole Eisenberger, a Partner at Ernst & Young, said the duration of this pandemic and the recovery thereof is really going to play a large role in valuations and company survival.

"How long this lasts is going to affect whether or not those investment companies that are on life-support are going to come out of this okay. And that's really where a lot of the managers are spending their time," Eisenberger noted.

While BDCs try to navigate the tumultuous markets for good investment opportunities, the question is why investors would be attracted to these structures.

According to David Miyazaki, a Portfolio Manager at Confluence Investment Management, one reason is that BDC are durable. While BDCs suffered during the previous financial crisis, there was not a systemic problem that required bailouts from the government, and this contributed to the industry's growth relative to the rest of the financial sector.

And BDCs proved to be resilient during the first half of 2020, Miyazaki said, despite significant credit risk throughout the middle markets and the rest of the credit markets.

Thompson added that another advantage of BDCs is that they are very liquid.

“If you're a fund manager or an asset allocator and you don't like the way the manager is running the fund, if it's public you just trade out of it. Your money is not locked up for five or seven years like it would be in a CLO or a direct lending fund.”

BDCs also tend to be much less leveraged than middle market CLOs or other funds, such as hedge funds. BDCs also have dividends, are mark-to-market and must be very transparent.

On the flip side, when speaking about the negative aspects of BDC, Nicole Eisenberger, a Partner at Ernst & Young, noted there is concentration risk associated with BDCs. “You should look at the schedule of investments to see if a BDC is heavily weighted in one industry versus another.

Before making an allocation, investors should consider what makes a “good” BDC, including management, transparency and the NAV change over time.

Troy Ward, a managing director at Ares Management, said during the Institutional Investor Panel: BDCs panel that when thinking about investing in the BDC space, investors must believe in the manager.

“First and foremost, you own the manager. So, you have to understand who you own and understand why they're building a portfolio the way they are. And you have to have comfort in that,” Ward noted.

Miyazaki said when looking at any financial company, the most important assets “go home every night.”

“Clearly, management is going to be of paramount importance. We try and focus on the managers that don't just sound good and look good but actually have demonstrated real results across time, and then look inside their portfolios.”

Another consideration for investors is differences in investing abilities and whether there is anything that traditional private equity funds and private placement structures can do that BDCs cannot.

The most notable difference is that BDCs have leverage limitations.

Dwayne Hyzak, Senior Managing Director and the Chief Financial Officer of Main Street Capital Corporation, said BDCs have the same flexibility that a private equity firm or a private debt capital firm would have when investing in portfolio companies.

“One clear advantage of the BDC model is the permanent nature of our capital structure. So, when you look at the investment activities that BDCs can and some do pursue, it's a different approach from an investment standpoint. If you are making equity investments, it's a huge benefit to be able to tell portfolio companies that you will be their partner for as long as the portfolio company wants you to be. There is not an arbitrary end-of-fund life structure issue that a traditional private equity fund or a private debt capital fund would have.”

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