Larger BDCs Weathering COVID Much Better than Those Targeting Lower Middle Market Businesses

By Jennifer Banzaca

BDCs with $4 billion or more in investments are weathering the impacts of the COVID-19 pandemic better than those that are targeting lower and middle market businesses.

During the BDCs From a Service Provider Perspective session at the Active Investment Company Alliance's (AICAlliance.org)'s Summer Summit on August 13th, Kelly Thompson, Founder and Editor of Direct Lending Deals, said non-accruals are "the main headline" for BDCs and why larger BDCs are faring better.

"Non-accruals were up in the first quarter, even if there wasn't a huge spike. So far in reporting for the second quarter, the numbers are definitely up generally across the board. Some BDCs that are focused on lower middle market and some of them have double-digit non-accruals right now."

For middle-market investors, there are advantages to BDCs over other funds that invest in the middle market, mainly liquidity.

According to Thompson, "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's not locked up for five or seven years like it would be in a CLO or a direct lending fund."

Thompson also noted that from a capital structure standpoint, BDCs are a lot less leveraged than middle market CLOs, which can be up to five to seven times leveraged, whereas BDCs are currently leveraged at one to one and a half.

However, BDCs are not without some negatives, namely higher management fees as compared to a middle market CLO.

Nicole Eisenberger, a Partner at Ernst & Young, added that there is also 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.

The transparency into a BDC's schedule of investments is important for investors to consider, with particular focus on how the pandemic will affect companies that the BDCs are investing in. Eisenberger, a Partner at Ernst & Young said the duration of the pandemic and the recovery is going to play a large role in valuations and whether companies are going to survive.

“How long this lasts is going to affect whether or not those investments are going to come out of this okay. And that's really where a lot of the managers are spending their time and tracking their investments very closely,” Eisenberg added.

As volatility and valuations have fluctuated, some investments have become riskier, thereby causing some BDCs to shift their investment focus.

According to Michael Shekel, a Director of Valuation Advisory Services at Cherry Bekaert, “The bigger BDCs tend to pull away from more risky investments and what is left for the smaller BDCs is the attractive but more risky investments. You see a wave of opportunities now for them that you wouldn’t see otherwise.”

As larger BDCs look for less risky investments, Shekel said they have shifted from investments in mezzanine financing and second-liens to just first liens.

“As larger BDCs try to be more risk averse, this is creating more opportunities for smaller BDCs.”

However, investing in such a tumultuous market and during a global pandemic is not without its challenges, Shekel said, as it can be difficult to get good information on portfolio companies, especially middle market companies. There is also a lack of guidance from managers and portfolio companies regarding valuations.

“At the end of the day, especially during COVID-19, we were always trying to get management guidance in terms of the new normal for the operating business and trying to get up-to-date financial projections. Without the guidance of management, it's a more challenging task.

Eisenberger added that difficulty in getting information from management to do valuations increases because different management is potentially going to have a different point of view on values.

“You have to understand the perspective of those valuing it and the information that they have available to them or what they're putting into the judgement part of arriving at that value,” Eisenberger said.

Adding to the difficulties in valuation, Shekel said, is lagging financial information for many assets.

“Because financials are not readily available on a daily, monthly, even quarterly basis, it’s hard to get to a valuation conclusion as of a specific date? We tend to use historical data and also make sure that we're capturing financial projections that are up to date, as well as management guidance,” Shekel explained.

He added, “We're not dealing with the stock of Apple or Microsoft where information and trading is available on a second-by-second basis. I think one of the key pains from the client perspective is, is how do you bridge direct pricing that they can get from a third party into a true market conclusion of their investments?”

investors daily liquidity but rather on a quarterly or semi-annual basis, often on a small percentage of share. CEFs often use leverage, which can increase 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.