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With a Majority of BDCs Trading Below Net Asset Value, Differentiation is Key

By Jennifer Banzaca

The need to differentiate from the competition is essential as the competitive BDC landscape tightens up, with more lenders bidding on the same deals and many BDCs trading below net asset value.

During the Premium BDC panel at the Active Investment Company Alliance's (AICAlliance.org)'s Summer Summit on August 13th, Scott Bluestein, CEO and Chief Investment Officer of Hercules Capital, said, "I think one of the things that you've seen with the majority of BDCs trading below net asset value is that over the last five to 10 years the competitive landscape has really tightened up. If there is a sponsor-backed company that's looking for a proposal, you're going to have 10 to 12 lenders all bidding the same deal. Generally speaking, in a lot of cases that's going to be a race to the bottom in terms of structure and in terms of pricing."

Given that many BDCs are trading below asset value, it is critical for firms to differentiate themselves. Dwayne Hyzak Senior Managing Director and the Chief Financial Officer of Main Street Capital Corporation, said, "If you trade at a premium, you need to be doing something that's unique and different than all the other BDCs."

For Main Street, Hyzak said the unique focus is on the lower middle market.

"This part of the market from our standpoint has been and continues to be underserved from a capital standpoint, and we think that that underserved nature of the market allows us an opportunity for a very favorable return on investments for our investment activities in that space," Hyzak said.

In speaking about how Hercules is different, Bluestein said that while the firm is a publicly traded investment firm in the broader direct lending business, it participates in a much smaller part of the market know venture lending, or growth stage lending.

Bluestein added, "The other nuance of our business is that in the majority of cases we also get some equity upside in the deals that we participate in. And that can be in the form of a direct share issuance, that can be in the form of a convertible instrument, that can be in the form of a right to invest which gives us the right to participate in a subsequent equity raise, or it can just be in the form of warrants."

To stand out from other BDCs, Barry Sloane, Chairman, President and CEO of Newtek Business Services, said that Newtek Business Services Corp. provides financial and business solutions to the small- to medium-sized middle market businesses all across the United States.

“We're fairly unique in that we own what we call portfolio companies, we own 100% of them. We're a lender and that obviously gives us the primary qualification for being a BDC,” Sloane explained.

Another differentiating factor, Sloane said, is that Newtek was also a fairly significant producer in PPP loans this year.

“We decided that we were going to stop making normal lending commitments and focus on the PPP program. The PPP program gave us the ability to make the loan and sell 100% of the loan off with our books. And when you played with the numbers, because you've got a certain amount of fees from the SBA for a small loan, a certain amount for a bigger loan, we averaged about 3.2 points for making a loan.”

Bowen Diehl, CEO of Capital Southwest, said his firm’s core business is the lower middle market, with the core asset class being firm lien lending. Diehl said the lower middle market is attractive because the leverage levels are typically much lower, allowing the firm to generate attractive risk-adjusted returns in the first lien security. The firm then often invests in the equity in the capital structure.

Firms have also had to find ways to perform well and stand out during the current volatile markets, adapting their lending practices to take advantage of the current market dynamics.

Diehl said his firm prepared for the pandemic by maintaining lower leverage on the BDC.

“Now we have the capital to invest, and we've seen spreads initially widen by 200 plus basis points, now probably more 50 to 100 basis points. We're absolutely seeing less competition in the lower middle market in where we play,” Diehl noted.

Hyzak said Main Street maintained a very conservative approach both to leverage and to liquidity. The firm also never requested the expanded leverage access that other BDCs have requested.

“As we look at our model, specifically on the lower middle market side and the asset management side, we're very comfortable that we can produce returns that are significant enough to reward the shareholder without taking that additional risk associated with the increased leverage,” Hyzak said.

Hyzak noted this has allowed the firm to take advantage of what could end up being some of the best investment opportunities over a cycle.

“We really look at this time as an opportunity where we expect to be active. We have been since the pandemic started and we're seeing what we think are very, very attractive investment opportunities. We're confident that as long as you're investing in really good companies, and more importantly, investing with excellent management teams, at a time where most other people are choosing either not to invest or can't invest, you're going to end up with a very good outcome.”

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