John Cole Scott provides welcoming remarks to the 2021 AICA BDC Investor Forum along with a presentation on "ABCs of BDCs".

Thursday, May 27, 2021

John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the 2021 AICA BDC Investor Forum with opening remarks and with a primer on BDCs. Read the transcript below to hear what Mr. Scott had to say to kick off this event.

John Cole Scott

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John Cole Scott: We're going to do the educational session, the ABCs of BDCs, currently. I hope you enjoy it. Feel free to type questions in the question box, and if they pop up I'll be sure to address them at the end of these slides.

So first we want to make sure you know what a business-development company is. They are basically a closed-end fund that provides small growing companies access to capital. They're closed-ended management companies that are kind of a hybrid structure with operating companies, the SEC filings are a little bit different but they still have those three things that I've always felt are important for a closed-end fund; the fixed-capital share base, the active management of holdings, and the listing for the liquidity for investors and shareholders.

They’ve been around since 1980 and they were modified and brought to Congress to allow for more diverse investment options than traditional stocks and bonds for retail individual investors. But just like closed-end funds, they are under the 1940 Act, they have fixed-capital, just like I said, they have active management and daily liquidity, and is a tax-advantaged structure so there’s no taxation at the BDC level. The dividends pass through to shareholders and then, if warranted, are taxed.

The leverage levels can be a little different than a regular taxable bond fund, little bit higher levels and there is some leverage SBIC facilities that aren’t counted in regulatory leverage, but there are some closed-end funds that do some interesting things with leverage too. But still way less leverage than a bank or a mortgage REIT traditionally has. BDCs have a generally higher fee structure, usually the funds that we typically like have high watermarks, and lookbacks, and hurdle rates so that it’s a fairer fee structure but it’s definitely a higher fee structure than you’d typically find in even the more higher fee fixed-income bond funds.

When we place BDCs into our universe they are one of the four major categories, and debt BDCs are one of the four peer groups that we use. If you think about taxable fixed-income funds with about 47 in existence and 149 traditional funds, they’re about 25% of the sector. However, they are about 70% of the same asset size as their larger sector and the yields tend to run a little bit higher. And the leverage levels like I said here tend to run a little bit higher; 40-50% is a normal leverage number for a BDC using traditional closed-end fund terms. So as we talked about, really it’s the chance for the capital inside the NAV of a BDC to be lent out through various loan type structures and then dividends or interest to be paid back to the BDC. And then those interest payments get paid out to shareholders as dividends which make them very attractive for income investors, especially those in retirement.

When we think about the portfolio allocation, it’s just under two thirds first lien, it’s about 14% second lien loans. These are kind of like but different than a first or second mortgage on your house. And only 5% are unsecured loans which would be more like a credit card. Eighteen percent ends up being equity or other. Some BDCs are very little exposure to equity other, some actually are very proud of going after the larger amounts of that. And there’s even a few equity BDCs left, they’re not very large and they typically haven’t traded very well so we don’t focus on them and they typically don’t pay any investors regular dividends.

The average portfolio turnover is about 29% and it’s a mix of loans, about 84% variable and 16% fixed. Just under half the loans have a LIBOR floor, the average floor being 1.4% currently. And there’s a lot of mix in here but the average size loan is $10 million and two thirds of the loans are under $25 million in size. That really speaks to the fact that you’re getting access to really small businesses, and the fact that it’s loans means that there’s a good chance to get the dividends off them to make them generally a safer investment than only an equity investment to a private or small business.

From a sureties average, 3.8 years with a range of two to six. And the typical BDC is really much more smaller BDCs than larger BDCs, but the average number of loans is 226 from 162 companies. What’s important about that is that you’ll notice there’s more loans than companies because there's many funds that will have more than one investment to a company. Sometimes it's a loan and an equity or warrant, sometimes it's two loans of different sizes or styles.

Looking at the yield, the yield for the funds come in higher than any other debt sectors that we focus on, even higher than some of the indices we use to benchmark income investing. What's really important here to me at least is that the blue line is the average market price yield for the group of funds. The kind of greyish green line is if you back out leverage and discounts, what the manager has to meet economically to meet the dividend policy of the board, which is what the dividends are being paid to shareholders. It helps you understand how "easy" that would be to make, and really is accentuated traditionally in BDCs because of their higher amounts of leverage.

Volatility, this is a slide we came up with after 2020, looking at one-year versus 10-year volatility of market prices and net asset values. And so the key here is that both net asset values and market prices tend to be a little more volatile in this sector and I think that speaks to some of the opportunity. Because if you're unemotional or less emotional and you pick good managers and pick some emotional spots of the market, there's some especially good times to get in. And we'd argue some especially good times to get out or rotate other sectors or different players in the portfolio.

It's hard not to talk about why own BDCs. Yes, it's access to parts of investments that you can't get easily in regular ETFs, open-end funds, individual securities, even traditional closed-end funds. It's a regular coupon payment, a little higher than many of the other sectors. But I think that movement and that diversification of the net asset value correlations are also really, really important to us. And especially as low correlations I find interesting to MLPs, and senior loans, and investment-grade funds. So it's not a perfect answer but it does tell us that if you're adding BDCs, you are adding statistically things that zig when other things zag. Though I will note in March of 2020, everything zigged or zagged, it was very little diversification across almost any asset class, any security. But you're invested for every day and every month of the year traditionally in retirement, not just the bad months, and it's nice to have diversification across much of the time periods that you have.

Because listed BDCs have that market price listing and trade on the New York Stock Exchange or the NASDAQ, it's important to look at their discount history. This chart works really well in my opinion, it comes from our BDC index which is available by linking both off CEF Data website but even on the conference tables on the right hand side is the link to that. And we saw discounts, NAVs went down after April of 2020 in that season, but then market prices went down way more. And while NAVs have recovered to high watermarks, so have market prices and probably a little bit faster and a little bit better. And those discounts are actually trading higher than they were pre-Covid in recent time.

So the average fund inside of that index, I think there's about 32 or 33 funds in the index right now, is currently on an average 11% premium and an 8.4% yield. Sorry, 34 holdings. I'll say some of this stuff, the average non-accrual is 1.6% for the index, a normal number is 2%. Below 2% is healthy answer for the sector and can get 3, 4, 5, 6 in a rough or true recession, more like the Great Recession than the Covid Recession.

Other thing I think might be important is that last quarter, to speak to this recovery, the NAV growth was 2.27%, which is really, really nice and to me, really, really important. And on this index, again it's 86% bond exposure so it'd be 14% equity.

This is the longer-term chart. It's not the index, it's the peer group, and so it's not as granular as we can do with the index pages but really should remind you of that movement of NAV and of market price and that we have had a very nice recovery.

A longer-term discount, we can go back 16 years with enough funds to make the discount chart make any sort of sense. A 4% discount has been normal and we ended March at a 2.5% discount, and it is a little higher now but this chart is updated quarterly. I'd say when the funds are getting to 20% premiums, that would considered high. Ten would be moderately high. Flat, normal market is a good deal. Discounts obviously are available in great recessions and time periods.

When I think about earnings season, really how first quarter ended, closed this week, Capital Southwest was the last one to update-- at least that's in our index and in our coverage universe. And when you look at the last three months, BDC net asset values are up 6% total return and market prices are up 14%, almost 15%, and I think anyone can argue that's a very successful earnings season. Year-to-date BDCs are up just under 30%, and on a one-year basis, and this is as of 5/26, up 62.5%. The three and five-year numbers are both annualized just around 12%; I think one's just above and one's just below.

And I think some of the people go, "The volatility was very significant on the downside, but how are we actually doing if you didn't sell in March last year, you held on?" And as of 1/31/20 BDCs are up almost 20% higher than that pre-Covid level, and the dividends in dollar terms, which we use our index to calculate, are up just over 5%. Which to me is a great success for the structure and great success for investors.

High-quality BDC managers prove they can navigate bumpy markets by working with their portfolio holdings and to work through Covid issues. That's important because we don't really highlight it all the time but one of the statutes of the BDC regulation is that the BDCs actually have to offer advice and support to their investments. Regulators put that in there or Congress did and I guess it makes sense. I'd argue if you're lending to someone a loan and it's a loan that you really have to hold until it matures, you have a really good reason to make sure they're in business and can pay off your loan. I think that you don't need to have that regulation to have that behavior happen.

People wonder how did BDCs really recover? It almost seems better than almost any other investment I can think of. If you have a great one, let me know. And I think it's partially because before Covid there was very low exposure to retail, hospitality, and restaurants. I think that that frontline service industry, it's a lot more focused on other areas of the market where they actually found a way to survive and thrive during Covid-19.

The IPO trends, there's less IPOs for BDCs because there's less of them than traditional closed-end funds. The way they come to market has changed over time, but if we think about the numbers we really have seen at least one come out every year except for 2016, and so far this year but I expect we'll see at least one before the year closes.

And if we look at the average size, really in the last three years those average sizes have been in the billions, and it was uncommon before that to have that. We often found small raises and then hopefully those funds could fuel secondaries if they traded well in the market. And we include the traditional closed-end fund IPO data just as benchmarking because while it's a little bit different mindset in how it's done and investor base, it really is a similar. It's generally a yield-focused investment that gets a lot of similar interest by similar investors.

That's basically it. We just want to make sure that you had all of the information that you might want to be more comfortable before the three sessions you're about to watch. And so hopefully this gets you well situated. I thank all the presenters today, I'm so glad to be part of this. I'm glad you're here and I hope each of you that's attending really gets the most out of this presentation. Thank you.

Recorded on May 27, 2021.

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