John Cole Scott provides opening remarks for the second Day of the 2021 AICA Business Development Company (BDC) Fall Forum Event along with a preliminary educational session on BDCs.

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John Cole Scott, Founder and Executive Chairman of the Active Investment Company Alliance opens the second day of the 2021 AICA Business Development Company (BDC) Fall Forum event with opening remarks and with a preliminary discussion on business development companies. Read the transcript below to hear what Mr. Scott had to say to kick off day two of this event.

John Cole Scott

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John Cole Scott: John Cole Scott, executive chairman and founder of the AIC Alliance. I want to welcome you to day two of our Fall BDC Roundtable and Investor Forum. We have another wonderful agenda today of three solid panels. I'm going to do a similar intro from yesterday, but we're going to try to move a little faster through it because we ran a bit out of time and we have a lot to say. But I would like to thank you for being here. We are a nonprofit trade association that focuses on BDCs, closed-end funds, interval funds. Our membership is made up of fund sponsors, those that use and build products of closed-end funds and BDCs and whatnot, as well as the service providers in the sector. Really it's meant to be broad based, inclusive, all of our content is invite to speak as an educational session.

I'm going to share my screen for this intro session. Perfect, so we're going to go through this. This slide deck has been PDFed, and if you were to go to our event page on AICAlliance.org, you'll actually be able to download this in PDF format which should be helpful to you guys going forward. So we want to make sure before we actually hear about BDCs you have a sense of what they are. So they are closed-ended management companies that pretty much primarily focus on doing loans into small US-based businesses, helping them to fuel growth and needs over time.

They're not brand new, they're from 1980. And they're very similar in their closed-end fund traditional cousins, they're under the 1940 Act. They have a relatively stable share count, which means every day generally the same number of shares as the previous day. There's no inflow or outflow mechanism, that is the closed-endedness of this listed structure for investors. The portfolios are actively managed, definitely when doing venture loans it is not a passive process. You'll find far more labor intensive than senior loan funds or high yield bond funds in the traditional neighborhood.

The funds we're discussing today are primarily the listed BDCs. And it's worth noting there are also nonlisted BDCs, both nontraded and private that do make up the ecosystem. We might have some content covering that at our spring event. But the benefit of most of the funds is that you as investors or advisors for your clients are able to access these funds in whatever dollar amount you decide with daily liquidity for adding or reducing the portfolio value. Just like other closed-end funds and other investment structures, they do have a passthrough feature so dividends are only taxed once. It's one of the many reasons why they're so useful and useable for an income based portfolio. But they can be a total return strategy as well.

One major difference is they can have a little bit different types of leverage and a higher limit than allowed in traditional funds. Still far less than other structures, as you'll hear about on some of the panels. But it's worth noting that if you see numbers that look bigger than you might be familiar with on a muni bond fund, a high-yield bond fund or a senior loan fund, it is still typically far below the limits that are either the rating agencies which you'll hear about in panel three, look at giving the funds a rating, a proper rating, as well as even allow their regulatory reasons.

Because the work is more detailed, ongoing, sometimes you actually take over a portfolio company, you'll hear about that on maybe panel two. They do have a higher fee structure and a carry, but you will hear some conversations on the first panel about how the fee structures can be very varied and some are more beneficial to investors, and some hopefully can be improved over time. This is the highlight just the number of funds in the listed universe, there is roughly the same assets or about $100 billion total in the total universe of BDCs. But just want to let you know the average is sitting there right now at a 2% discount, but you'll see in a later slide our index is actually much higher because that avoids small BDCs and equity BDCs of which there's still about four.

Visualization of what actually happens, what is the business of a BDC? Basically they raise capital, they write loans, they get paid interest in the loans, they pass out dividends to shareholders, they cover their cost, and they move forward. That is essentially what a BDC is. If you think about the types of loans in the portfolio, basically almost 80% are secured loans. That is different than you might expect. People probably when they first find BDCs expect them to be like high-yield bond funds which are generally unsecured debt, and these in difference are usually secured at some level in the capital structure, as well as they are as you'll see they're mostly variable later on.

Only 5% is unsecured loans. And the next bucket, equity/other, it really is more of an other than an equity, it includes rights, and warrants, and preferreds, and just anything that's not simply a loan. And you'll find BDCs tend to be above 96% loans or typically below 88% loans as they're choosing to use equity and other pieces, could be CLO exposure, as an additional component of their total return and income work for investors.

People wonder how can you have turnover at 34% for a private portfolio, and it's because of two things. There are pre-payments, because as companies get stronger they can come back for a better terms on maybe a larger loan. These things typically are average of four-year life and can often get paid back sooner, like I said, if you are improving as a company, as well as just the general nature of the portfolio changing over time.

Eighty-four percent of the loans are variable, it was a little lower when we started adding data to CEF Data in 2014, but definitely a big part of this sector is those variable loans. LIBOR floors, which we had a little bit of discussion on a panel yesterday, but right now half the loans have the floors and a 1.3% is the average fee level. For a while it was important, than it wasn't, now it's important again.

But really going back to I think the interest and the why you should be considering BDCs for your client portfolios is the average loan size is $10 million. If you think you're getting that type of investment with other structures, you're in a private fund and typically don't have that liquidity and the other benefits of the RIC structure for a BDC. And two thirds of the loans are under $25 million, so that really is, yes, there's some big loans in there. You heard on the panel yesterday with TCPC at Owl Rock about the size of their loans and how their business is different. Today you'll hear from Capital Southwest and Saratoga who work in a different part of the market and how they work with their clients and write their loans. And like I said, the average maturity is under four years. Inside of the average BDC it's basically 239 loans and 166 companies.

When we think about the indicated yield for the peer group, and this is any debt BDC, the blue lines here is the indicated market yield based on the current dividend policy of every BDC. There's about 44 in this mix. The light green line is basically if you were to remove the impact of leverage and discounts or premiums, about what's going on at the portfolio investment level for the manager of the assets. I really like to remind people that BDCs in the current environment have an almost 100 basis points or 1% over the CCC loans. Yet in almost every case, much of the investments for almost every BDC are in my opinion, and this is the opinion brush, safer than almost every CCC loan. And if you think about the economic return required to fuel it, it's right around the same. Actually technically slightly lower because there's more leverage than the senior loan funds giving you extra yield.

I find this slide really helps explain why you often find higher yields in listed structures. Those as you'll see on panel one, we will talk about just because a dividend is being paid doesn't mean it's being earned. But we figure in a group of this size it does help you understand where those yields stack up and how they are available. And these slides come from our quarterly research call, you can download those every quarter off our CEF Advisors website.

Volatility is always a factor with investing. I think anyone that's been in this sector understands these have higher volatility. I want to just include this going forward to make sure you have a sense of where volatility has lived. And we do offer this in our system. Starting January of '22 we'll have a 10-year number because our CEF dataset will turn 10, which we're very excited for all the extra data and charts we'll be offering people.

The correlation chart, this is one way we initially help to explain to our separate account clients at Closed-End Fund Advisors why we added BDCs. We had data, and perspective, and thought we could pick good managers and be tactical over time, but we thought they really added a correlation benefit to other fixed-income asset classes. Now this is the full 14 major sectors of closed-end funds that we use, because a lot of our client portfolios are between 40% equity and 60% equity in the net balance in the other side of that half. And BDCs to us are considered loans, but they do act a lot like equity.

This is just taken on Tuesday morning from our index page for closed-end funds, or BDCs in this case. This is if you are a debt BDC and you have a million dollars of liquidity, you're equal weight in our index and we use that to really benchmark our separate accounts, look at other things in the market. Really like the way it's equal weight and just a very good way to have no human perspective on quality but just show what's available in the market. What I find useful on this slide and important is that while you've had a bounce recently in BDCs, their relatively premium levels are below June of '21 because net asset values have grown so much since June of '21.

This is the data off that index and you can get to it every day publicly on our system. Basically average BDCs at just under 15% premium versus a five-year 1% premium, and the 8.2% indicated yield of what's available there. The other two data points I'll focus on are in the right hand lower corner, and as the adjusted core NII coverage for the 29 ticker symbol index, the average core NII is 104.9% over the current average dividend policy on an equal weighted basis.

Nonaccruals, which is the new-- not the new, but it's the way you think of nonpaying loans in BDCs. It's called defaults typically in other bond fund structures. But we're still at a very low historical level. Even at the peak of Covid and even during 2008-2009, this data didn't get above mid-single digits. Which is I think pretty impressive and reminds you why you can find long-term success with a BDC in having the loans get paid back and while dividends are constantly changing, a chance to get above average yield. I think as long as you do good work and you're willing to change your mind but not react emotionally, add a lot of value to your client portfolios.

This is a 10-year total return chart, this includes dividends. We like to include this because sometimes people only look at the stock price and can't forget that dividends are a heavy part of the closed-end fund outcome. This is that more granular discount chart, looking at it historically for 16 years, that's as far back as I'm confident in our dataset. And we're basically about 4% over this longer term average. But again I would argue, this is the opinion brush, that we're only 3% over the median and there's not a lot of other places to go. And yet I think there's still a lot of legs in the underlying holdings. And even though no investment's perfect, I like the opportunity set in BDCs looking into '22 and '23 for my clients.

This is really hard to see but I want to just highlight, this was as of Monday in our earning seasons dashboard, one of the tools we've built on CEF Data to help understand and organize what's available. I just want to talk about the first column is in red or green, this quarter was the dividend increased or reduced. As you might expect, green is increased, red's reduced, and more increases than reductions. Dividends move around consistently, they're never very stable for very long for most BDCs or even most bond closed-end funds. So I have a three-year dividend growth rate, same thing. Green is up, red is down.

What I wanted to do is I was pulling two other pieces of the data we look at. One is that third column of mostly reds, is fair market value to cost, and I only highlighted things that were over 1% down and honestly could have made that a little tighter if I wanted to. But there are some funds, if you look at some of the big negative numbers. If you can see this screen, if not remember pull the slide deck and you can look at this later. If you can't read the slides, I'll help you see access, just email me directly. That the fair market value of cost when BDCs are successful at not losing money on their loans, and then the next column, the last column not losing net asset value. As in having green is the growth of net asset value and red is reduction.

You often find, though it's never perfect, which is why investing in BDCs is so interesting because there's no simple one rule for everything. But the dividend growth color coding and the five-year NAV growth, remember that's not NAV total return, that's NAV growth, are often similar. Because traditionally very hard to maintain a dividend when your NAV is falling. Again, some more color on that at the next panel because it's going to be a great one.

This last piece, and this is basically the end of the session and we'll go right to the presentation. I want to just comment that where BDCs are since the last time we did this conference, NAVs are up 8.6%, market price is up about 11%. If you think of the last rolling earnings quarter, we're almost through earnings quarter but not quite, NAVs are up 3.5%, market prices are up 4%. So discount narrowing in the last 90 days has been a lot less than it was last time we had this conference and even the previous earnings quarter. This year, very successful year, but again a very rough 2020, March of 2020 for BDCs. They're up about 42% on average year to date, and a one-year basis. If we had held this a year ago, which we probably should have but didn't have the resources at the time, up about 54%. The three and five-year numbers are sitting there, 5.7%, 10.9%. And I'd like to say that BDCs are up in market price total return terms, 26% above their January 31st, 2020. And the dividends in dollar terms from our index, to make it simple and diversified, are up about 13% from pre-Covid.

So we don't know the future but I just want to remind people that dividend levels and percent terms are down, but in dollar terms they're up. And it's a great place to consider for your clients. The last thing I'll just talk about is the overall exposure, for those that aren't familiar, 15% in IT services and equipment, second place at 12.6% healthcare and pharma, and the third is consumer products at 11%. So if you like those sectors, BDCs are a great way to go. This is just some other stats that are going to be in the thing. I'm going to unshare my screen and I'm going to invite the next panel to come on.
Recorded on November 17, 2021.

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https://AICalliance.org/

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