A Check On BDC Developments, and Performance versus REITs

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Stephen Hester, partner at Wide Moat Research and editor at the *Intelligent REIT Options Advisor* newsletter. Read the Q & A below as Stephen offers his take on new developments within the business-development company realm, and compares how current market conditions are making BDCs an attractive alternative to real estate investment trusts, noting that the standard BDC cycle periodically makes them a buying opportunity – especially compared to REITs – and one of those times is now.

Stephen Hester

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Stephen Hester, partner at Wide Moat Research is here, and we're talking business-development companies and how they shape up compared to real estate investment trusts, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond

indexing, The NAVigator's going to point you in the right direction. And today we're going in the direction of business-development companies with Stephen Hester, who's a partner at Wide Moat Research and is editor of *Intelligent REIT Options Advisor*. You can learn more about the firm and about the newsletter at WideMoatResearch.com. To learn more about BDCs and closed-end funds go to AICAlliance.org, the website for the Active Investment company Alliance. Stephen Hester, welcome to The NAVigator.

STEPHEN HESTER: Yeah, thanks for having me, Chuck.

CHUCK JAFFE: There's been relatively speaking a lot of activity in BDCs of late. I say relatively speaking because the entire BDC universe is only like 50 companies, but we've had a couple of new ones and there's a bunch of stuff that's being talked about and in registration. So let's start there, because there are more and more people interested in the structure and what the structure can do and allow them to bring to market. Are you finding a lot of interest in the new stuff out there, or is it the established things that are just having some sort of an advantage for you?

STEPHEN HESTER: I think it's a healthy mix, Chuck. It is always fascinating, in a way sort of fun to analyze new entrants in the space. One of those I recently offered some research on was Blackstone's new BDC. And it's effectively brand new, just a couple weeks old, and it grew up to $7.5 billion in assets. So despite being private, it now makes it one of the biggest BDCs period. I always enjoy looking at new entrants, Munro, Bain Capital, in this case Blackstone. A lot of great Wall Street firms have built capital slowly on the private side where I spent most of my career, and then had pretty successful initial public offerings in the public space, opening that up to a lot broader investment base.

CHUCK JAFFE: In fact, it's opening it to a broader investment base and it is bringing some things that are maybe a little bit different to market. But the place that BDCs hold for many investors is the place that real estate investment trusts have held for many investors for many years. Of course with your newsletter you're looking at REITs all the time, so let's do a little comparison there. Because if there are people who are into REITs who have never been into BDCs, maybe this'll open their eyes.

STEPHEN HESTER: Yeah, I agree. I find that in the retail community, that there's a lot of overlap in interest, and I think as they get more educated that overlap makes a lot of sense. In terms of similarities that you mentioned, both of these, particularly compare to bonds,

treasuries, etcetera, these are great income investments. Long track records, what I call the yield premiums, so that's going to be what percentage yield are you getting off the investment compared to some benchmark like corporate bonds. For REITs, even the lowest yielding REITs are usually around 200 basis points or 2%. And with BDCs, even pretty high quality BDCs, this goes up as high as 800 basis points. That's an extra 8% in annual income you're getting over what we call traditional fixed income like investment grade bonds. And part of the reason that the yields are so great, there's no free lunch so to speak, but sometimes you can get a free snack. And in this case both REITs and BDCs enjoy preferential tax treatment. That preferential tax treatment blows down to us as investors and gives us that little bit of extra yield. Obviously there's tons of great quality traditional C-corps with really good yield that have long track records. The truth is when you compare those to REITs and particularly so against BDCs, big yield bringing in between those two. And the other issue that's I think kind of interesting that we're all facing where BDCs and REITs can help a lot is inflation. It's all over the news. Investment professionals are always worried about it and I think just about everyone's worried about it now. Whether equities or real estate is the best inflation hedge, kind of depends on the timeline you look at, but generally number one and number two historically. And BDCs are up there as well with floating rate loans. Blackstone, we just mentioned their new BDC, 99.7% of their portfolio, floating rate. So as rates go up, that income that goes to you as the investor also goes up. Of course no guarantees there, but that is the structure and I think that really helps. There's some differences too but I think those are some good similarities to mention.

CHUCK JAFFE: The other side of this is that like REITs, BDCs tend to go through cycles. But their cycles aren't always synced up. As I've been watching the BDC space evolve, it seems to be kind of even years are good buying years, odd years are maybe good making money years but not such a great buy. But it's not always synced up with real estate, so is that part of it too, that investors are looking at both because at various times one offsets the other?

STEPHEN HESTER: Yeah, that's a great point and one that I think frankly most people are not cognizant of. So just as an example for BDCs, and anyone can pull this up on a chart of their favorite BDC or by looking at an ETF that includes BDCs, almost like clockwork, every 12 to 14 months there's a great buying opportunity. So if you look at early 2016, a really quick correction a lot of us frankly forgot about in December of 2018, and obviously much of

last year, BDCs were a great buying opportunity. The active management component I think is extremely critical here. As you can see on those dates, yeah, REITs may have had some trouble there, but BDCs tend to trade a little bit closer to junk bonds. Whether they should or not is a different argument, they just kind of do, and that can be a great buying opportunity. If there's weak activity in call it lower investment grade, [inaudible] junk bonds, there's a really good chance you're going to be able to pick up your favorite BDC at a discount. And REITs aren't necessarily going to respond to that same sort of macro situation.

CHUCK JAFFE: One of the interesting things watching BDCs is that there's a lot of talk about what could go in there. We watch the investment industry, and everybody's looking for a place for could you have crypto or where can you have cannabis, or whatever it might be that's hot. BDCs have been kind of the antithesis of hot investments, but there's a lot of interesting talk right now, what do you think's coming down the pike?

STEPHEN HESTER: You know, you're right. Most of BDC success has been with fairly boring industries. Some of my favorite sectors, enterprise software, if you think of SAP type software. Distribution centers and companies, things like that. But BDCs really only have one restriction, and that's that the majority of their assets need to be here in the US. Otherwise they can pretty much loan anything. So it's certainly possible that BDCs will go more into cannabis, mining, crypto mining for example, those areas. There's nothing stopping them, and I think as those pretty conservative asset managers get more comfortable with it, it's going to happen. With REITs for example it already has. There's one publicly traded industrial marijuana related REIT, and there's also a mortgage REIT, AFC Gamma, that is focused in the sector. So I think it's just matter of time, and I think we'll start seeing frankly most of the large BDCs like Blackstone, like Ares, that it's going to make sense to go ahead and allocate a relatively small, modest portfolio of the portfolio into these growth areas provided they can find those private companies with pretty good financials to back the loan.

CHUCK JAFFE: And lastly, how are BDCs when it comes to inflation sensitivity? Because of course right now that seems to be everything to everybody.

STEPHEN HESTER: The way I would look at this is with two lenses. The first is, is the BDC's portfolio primarily, maybe even exclusively, floating rate loans? That's the first step. If it's mostly floating rate loans or like Main Street, a really popular BDC, have a good allocation to equities, equities are also generally speaking a pretty good inflation hedge. You're off at a

pretty good start. So there I would say you passed the first hurdle, which is it has the potential to do pretty well. The second one is, all right sure, these are floating rate loans, but are they tied to portfolio companies that can deliver in an inflationary environment? And that's when you have to do the old school due diligence, analyzing those industry exposures, analyzing those individual companies. One of the benefits is in every SEC filing you're going to see each one of those loans laid out with terms. So as an analyst it does take a little time, or an investor, you can go through and get a pretty good grasp on is this BDC loaning to companies that when interest rates do rise they're going to be able to pay those higher interest rates that the BDCs going to charge? And if they do, you're going to have an excellent inflation hedge. As soon as LIBOR starts ratcheting higher with interest rates, that immediately accrues higher income to the BDC, which they can use to pay higher dividends to investors. So at the very least you have a lot better dividend coverage making the investment less risky. Historically anytime that dividend coverage gets above a certain threshold, call it 120%, that's going to have management, in this case a board of directors, really, really tempted to increase the dividend to investors. So not only is that pretty good, but I think it makes sense to look at it versus the alternatives. And sure, REITs, they have a pretty good track record as well, but compared to other options in fixed income like fixed-rate bonds that we're all accustomed to, the BDC in my opinion is way, way better situated.

CHUCK JAFFE: Stephen, really interesting. Thank you so much for joining me to talk about it.

STEPHEN HESTER: Yeah, great to be here. Appreciate it, Chuck.

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