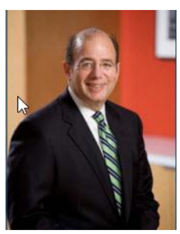
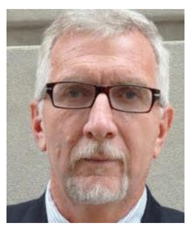
2021 AICA Business Development Company (BDC) Fall Forum Day 2 Panel #1; "BDCs From the Analyst Perspective"

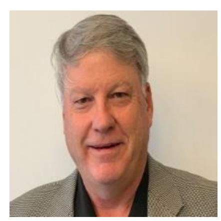
Wednesday, November 17, 2021

John Cole Scott, Founder and Executive Chairman of AICA moderates the opening panel of day 2 of the 2021 AICA Business Development Company (BDC) Fall Forum; "BDCs from the Analyst Perspective". Read the transcript below to hear the discussion among Mr. Scott and panelists Mitchell Penn from Oppenheimer & Co. Inc., Nicholas Marshi from BDC Reporter, and Casey Alexander from Compass Point Research & Trading.


John Cole Scott


Mitchell Penn


Nicholas Marshi


Casey Alexander

To view the rest of the conference events and panels go to:
https://aicalliance.org/aica-event/bdcfallforum2021/

John Cole Scott: If Casey, and Nick, and Mitch can come on stage. Two out of three ain't bad, let's see if we can get all three loaded up. Now Mitch was on this six months ago, so I know Mitch can come on stage. Click your camera on, turn your mic on, Mitch. I see I overdressed, but if I get too close to the camera you get those blurry things from my blazer, I apologize. We'll do this, I'm sure someone on my team is helping Mitch presently or hopefully Mitch was taking a coffee break. Why don't we start with a one-minute introduction, we'll start with Casey. Just real simple, your firm's business in BDCs and your background in BDCs. We have a great panel, I'm going to keep as tight as I can. Because if I can't keep us on time, no one should be able to. But please start, Casey.

Casey Alexander: Thank you, John, and thank you for having me on the panel. I'm a managing director and equity analyst for Compass Point Research & Trading. We're an institutional only firm, so while BDCs are often considered to be the territory of retail investors, I can assure you that institutions have a great and growing interest in BDCs and it has been really an excellent business for us.

John Cole Scott: Perfect. How about you, Nick? Or Nicholas? I always forget which one to call you.

Nicholas Marshi: You can go either way. My name is Nicholas Marshi, thank you all for being here. I'm looking forward to this conversation. I'm the editor of the *BDC Reporter* and the *BDC Reporter* has been around for about 10 years, and we are specialized in covering everything that happens in the BDC sector. We have several thousand subscribers. Everybody who might be interested in this subject from individual investors to institutional investors, as well as the BDC managers themselves and everything else in between. I've been involved in the BDC sector in one way or another for about 20 years and I have plenty of thoughts to share with you.

John Cole Scott: You do. And Mitch, it looks like we had a tech issue with your authorizations but now you're on stage. Welcome.

Mitchel Penn: Okay, great. Can you hear me?

John Cole Scott: Hear you wonderful.

Mitchel Penn: Okay, great. So I'm Mitchel Penn, I'm from Oppenheimer, I'm the BDC analyst. I started my career as a CPA at Price Waterhouse then I went back to school, got my MBA at University of Chicago and came out and was an analyst and portfolio manager in fixed income for 14 years at AETNA and Legg Mason on the buy side. And then moved over to the equities, I worked with a guy by the name of Bill Miller for 12 years where I was an analyst and portfolio manager and ran the FIG team at Legg Mason. Then I moved over to the sell side at Janney and covered BDCs for six years. The whole BDC team from Janney came over to Oppenheimer this year. We focus on over 30 BDCs. We cover both the equity side and the fixed income side for all types of investors.

John Cole Scott: Thank you, good background. Audience, their full bios are also available on the agenda website if you click their name. So first question, we'll start with Nicholas. I came to BDCs, as many advisors I find do, as a closed-end fund initial investor. That's a much larger universe. So as you think about premiums and discounts, it's common in closed-end funds, buy the widest discount for the senior loan fund, the high-yield bond fund, etcetera. How in your experience are discounts and premiums different for the BDC structure?

Nicholas Marshi: Well, premiums and discounts are very interesting and very easy to see. You can just check the NAV and the price, and so it does draw a lot of people. But when I'm in my investing mode, which I also do and have been for the last 12 years in my own fund, we tend to discount that. We don't look at that at all really [inaudible] element. More focused on the projected dividends that we expect to receive over the long term and what the market is likely to pay for those dividends, which varies very much by BDC. It's a much more difficult number to get your arm around, and obviously it changes all the time, which is one of the reasons BDCs fluctuate in price so much. But we've found that's the best way to analyze the value of BDCs.

John Cole Scott: Casey, do you have any color on that to add?

Casey Alexander: We certainly spend a lot of time looking at the price to NAV and the relationship to the price at NAV. We don't think of discounts or premiums as necessarily good or bad. We're essentially trying to assess the fundamentals of a BDC and determine what we believe is the correct price for that BDC. And then determine whether or not the current price, be it a discount or a premium, still offers an attractive return relative to that price that we think is the correct price for that BDC. So to us it's just a condition of pricing and a determination of what the right price is.

John Cole Scott: Kind of like operating companies, there may be a book value but less focus. And this is one way BDCs are more like operating companies than like traditional closed-end funds. Great, so the next question, we'll start with, let's see, let's go with, we'll start with Casey again. Apologize for that. We have recently seen a lot of BDCs come to market, there's been different ways they come to market. There was a push after the Great Recession of new funds. But maybe just talk about as you see BDCs maybe involved to some degree in them coming to market, what's the normal process? When you see a brand new BDC what should we be looking at? What's your experience there with new public listings?

Casey Alexander: We've seen two different methods for arriving as a public company. The traditional IPO form where a company comes to market with a BDC that already has an established platform and is raising capital to add to that platform. And then we've also seen a number of what are called direct listings, where the BDC has been a private BDC, is coming public but not raising new capital, simply listing those shares on an exchange. Generally they've been the New York Stock Exchange, but not exclusively. And providing liquidity for those private shareholders that have been involved with that BDC for some extensive period of time. [inaudible] Our observation has been that the IPO method generally settles into the [inaudible] market better because it seems to be more supported by the analytical community.

Whereas the direct listing seems to be driven by the need for liquidity by private shareholders who as soon as it comes to market take advantage of that liquidity and tend to drive those BDCs to an extraordinary discount to NAV relative to their fundamentals. So each offers a different type of opportunity, but those have been the two primary ways that we've seen. Last year we saw FS/KKR II direct list, and go to a significant discount. This year we've seen CION Investment Corp. direct list, that has also gone to a pretty significant discount. Those have subsequently recovered quite a bit from those discounts but also still trade at some discount to NAV. And then in the traditional IPO market we've seen a couple of good venture debt BDCs come to market, which is Runway Capital and Trinity Capital. And Trinity has certainly faired very, very well in the aftermarket. Runway was just done a couple of weeks ago so that still seems to be finding its feet a little bit.

John Cole Scott: Now Mitch, do you have any additional color to add to that perspective?

Mitchel Penn: No, I agree with Casey. We look at what those companies have earned in the past, what their loss rates look like. And that helps us form an opinion on what we expect them to earn in the future. I think the important point that Casey made is that there are inefficiencies in the BDC market. You don't see that in a lot of different markets, but in this market you do because the liquidity is relatively low. And as Casey mentioned, you have a situation in some of these private BDCs where the investors need liquidity and they're selling to get liquidity. It's not a statement that they don't like the management team or they don't like the earnings. They just want liquidity and you don't know why that might be. So the point here is there are opportunities. If you're paying attention to the BDC market there are some investment opportunities here.

John Cole Scott: Thank you. My next question we'll kick it off with Nicholas. So BDCs have different fee structures, and we may even want to throw in the internal and external component to this question as well, but how do you look at the fee structures? How should you consider them? What's the stuff that most advisors and investors probably miss?

Nicholas Marshi: As you said, there are really two types of BDCs in terms of compensation. There's the internally managed BDC where you as a shareholder are basically paying the managers to run it. And then there is the externally managed BDC where typically some big name asset manager is advisor to the BDC and receives a compensation in the form of a management fee, and incentive fee, a capital gains fee, and also a sharing of their operating costs. Generally speaking internally managed BDCs have lower fee structures than externally managed BDCs. But at the end of the day just because you're internally managed doesn't necessarily mean that you manage your business better than an external BDC. So just to complicate the situation, there are good internally managed BDCs and poor ones, and vice versa on the external side.

Unlike many closed-end funds though, the fee structures of the externally managed BDCs vary really quite hugely for the people who are used to closed-end funds, and I used to invest quite a lot in closed-end funds. So you can have some management fees as high as 2% of assets, down to 1% of assets, and that's obviously a huge thing. Incentive fees also can vary and there are many ways they can vary besides the percentage that they charge. And again, a higher fee structure doesn't mean it's a bad BDC, but it will make a very big difference to your return over time.

What we look for is a more nebulous thing, just how shareholder friendly in general is the BDC manager, an external manager? Which includes compensation, but includes other things like for example, if they're having a couple of bad quarters, do they choose to waive fees? Or do they say, "Tough luck friends, we're still charging the same fee"? Do they have a lookback feature or do they not? And these things will vary your return over time, so it's important to know what those fees are and decide whether you can live with them when you invest in BDCs.

John Cole Scott: So Casey, I know on the prep call we kind of extended this conversation talking about the way fees and leverage intertwine. Do you want to maybe add some perspective on fees and how maybe you would suggest management consider expense ratios as they get a larger amount of leverage on their balance sheet?

Casey Alexander: John, we have seen graduated asset based fee reductions put into place. A lot of those came into place as a result of the Small Business Credit Availability Act where BDCs were offered the ability to increase their leverage from 1:1 to 2:1 times. As a way of rewarding shareholders for voting for those provisions, they instituted graduated fee reductions based upon the increase in assets on the balance sheet. And that's fine. As it relates to the internal versus external debate, there are some folks out there who just say, "Internals great, external's bad." And frankly, we're not the morality police of structure, that's not the job of a securities analyst.

A securities analyst is the arbiter of price, not the morality police. And so our job is to determine what's the right price given the structure that is presented to us. And if it's higher fees, generally if there were two BDCs that had the exact same returns and one had higher fees than another, than arguably one would have a lower price target than the one that had the lower fee structure. Then it just depends upon what price does that trade at and does that offer an attractive return for investors to invest in? So we're a lot more agnostic about structure and far more interested in price.

John Cole Scott: Great. Now Mitch, I'm sure you have some opinions on these details. Would you mind sharing any differences you have?

Mitchel Penn: Yeah. So we focus on return on equity, and because of that, you're right, the internal managers tend to generate a little higher return. But as Casey points out, that higher return could be priced into the stock. So you're always trying to figure out what expectations are baked into the current stock price. And so we're sort of agnostic between internal and external, we find good value in both sides. What we do find in the internals is sometimes you see that the market expectations are too high, they're expecting much higher ROEs than those businesses have achieved. So you just have to be careful. I would also say on the externally managed BDCs, those incentive fees are so complex. When you're investing, just make sure you understand the mechanics of how those things work so you form the right expectations.

John Cole Scott: Very helpful. We do have a question that came in and it feels like maybe the right time to answer it. It did come up on prep call, but I'll let Nick just give a brief perspective on it. BDCs went through '08-'09, so when we were stepping into Covid, think of what you were writing from March 23rd to maybe April 10th, what you were thinking before maybe the bottom was known. How did BDCs handle 2020 versus '08? And what were your opinions and thoughts of their progress through a challenging last year?

Nicholas Marshi: You don't mean about fees, you just mean about performance?

John Cole Scott: Performance. So I would say to me this would be NII, this would be performing loans, would be the different decisions they made to navigate the path.

Nicholas Marshi: Well, it was a funny time as we all remember. And BDCs are run by humans, and many BDCs managers were very worried. The older and the more experienced ones the most. Several of them cut their dividends in advance or suspended them, others warned us that things could get really rough, "Please buckle up your seatbelts." On the other hand there were others. I'm afraid there's always on one hand, on the other hand sort of situation. There were others who had a capital structures that were right down the road and were able to continue almost normally. Except it was an abnormal situation, so it wasn't like there were a lot of loans to be made or anything like that. But they didn't have to cut their dividends and they didn't have to take any sort of special evasive action.

But overall for somebody who lived through the Great Recession with great fear and trepidation for months and months and months, the BDCs went through Covid at the worst time, which is only about a three to four month period, really quite well. I was very impressed. Their capital structures held up, management was reasonable. And given that their earnings had just been slashed by LIBOR dropping to zero percent effectively, they did extremely well.

John Cole Scott: Very good. I'm going to maybe circle back to Mitch, really maybe just chat. In my career and longer for yours, turnaround stories in BDCs. And I maybe touched on it in my intro session, some of the really bad fair market values or dividend changes are because there's a new manager in place. What has been your experience in watching the previous turnaround stories for BDCs? And maybe if you have any color to add to the ones in progress.

Mitchel Penn: Sure. So what you typically see at first is they realize they've got an issue, and they either bring in new management or they change the underwriting strategy, for example to go from second liens back up to first liens. And that's the first approach. If you look back, that worked really well. I think GLAD and GAIN brought in Bob Marcotte and Dave Dullum in the '13-14 somewhere in there, and those guys have done terrifically. You can see the ROEs have really picked up since they've been involved in those BDCs.

If that does not work; if they can't hire new folks and the new strategy doesn't work, they sell. And you've seen this with TCAP selling to Barings, and you've seen it with Fifth Street selling to Oaktree. The new management team comes in and they implement their strategy. And you almost get a good bank, bad bank. You have a legacy portfolio and you've got the new portfolio, and you can watch the performance of both. So TCRD sold to FCRD, and First Eagle in its last presentation book shows the legacy loans, when they were originated and the losses associated with those legacy loans. And you get a pretty good sense of how that's going. What you typically don't see is a BDC that liquidates its portfolio and closes the BDC. Typically somebody comes in and buys either the assets or the BDC.

John Cole Scott: Interesting. So Casey, I'd love for you to maybe add any color to that, but I also want to tee you up. I am making some changes on the fly here as I try to figure out the timing and how the conversation going. But we had a nice conversation about where earnings are for BDCs currently and whether it's peak earnings. And so if you want to add any color on transition for BDCs, but then talk about where you see earnings. At least for those that you cover, where they come, and where do your models suggest they're going based on the inputs you have?

Casey Alexander: Yeah, thank you, John. First of all, let me say I love Mitch's description of good bank, bad bank. Because we've seen that with a number of BDCs that have worked through legacy issues to the point where when you hear the term legacy investments, investors have learned to cringe. And it takes a while to work through that issue and regain ground on NAV. We certainly see that with FS KKR and the symbol there is FSK. Where KKR took over that portfolio that had originally been originated by GSO Blackstone and there were problems in that legacy portfolio, and they have worked through them. That legacy portfolio is now down to 16% of assets and yet the shares still trade at a 20% discount despite the fact that KKR's performance has been excellent. And KKR has added alpha to the portfolio with the assets that they added to the portfolio. So that legacy portfolio is wearing itself away, but reputationally it tends to stick around in investors' minds for longer than most people think.

To Mitch's point, Bob Marcotte came in 2014 and took till 2020 for the market to recognize it, and recognize that something had really changed beneficially. Sometimes it just takes that long. As it relates to earnings and peak earnings, frankly we think there's a very little chance that we are actually at peak earnings in the cycle. Because as you go through an economic cycle, the latter part of an economic cycle is generally characterized by rising interest rates and BDCs are asset sensitive towards interest rates. It is likely that when interest rates do start rising, and if you look at the forward curves of LIBOR, they're suggesting by 2023 we will be above the floors of those loans in BDC portfolios and that asset sensitivity will start to kick in. At that point in time there will be a very quick increase in earnings for BDCs, so we don't think we're anywhere close to peak earnings for BDCs.

As well, the venture debt BDCs, their floors on their loans are not LIBOR based, their floors are at the rate at which the loan was made. So as soon as interest rates start moving higher on the shorter end of the curve, and they price towards prime rate more often, those yields are going to pick up immediately. So venture debt BDCs will immediately start to move when interest rates start to move up. Again, we think that's clear evidence that we're not likely anywhere near peak earnings at this point in time in the cycle.

John Cole Scott: So just as a good moderator would do I'm going to say, which are the examples of venture debt BDCs for the audience? Because I think all of us know the answer but others may not.

Casey Alexander: There's really five publicly traded venture debt BDCs, and those would be Hercules would be the largest, and then you have TriplePoint, which has been around since around 2014. Horizon Technology Finance which has been around since 2011, and Trinity Capital and Runway Capital, both of which came public this year.

John Cole Scott: Thank you for that help. We'll make sure those are posted somewhere as well, in the transcript at the least. So Nicholas, so this is a nice transition point for us, kind of thinking about how earnings are generally connected to dividends. I know in reading your research regularly how much you opine on dividend trends, and changes, and the models. So if you could talk about the dividend component for investors. And how sustainable are BDC dividends generally, and what are the things you look for to make that assessment?

Nicholas Marshi: Well, once again every BDC has a different strategy for how they pay out their dividends. Some of them like to make their money and pay out as little as they can in dividends. Some of them pay out more in dividends probably than they're earning on the hopes that they'll catch up with their dividend. Some like to pay you a nice regular dividend every month or every quarter, while others like to do that and then give you a special. And then others will sometimes give you as a huge dividend as they catch up and they clean out their dividend shop and they give you a big dollop of dividends. So you have to become familiar with each BDC's philosophy.

But looking at the numbers, because we project out the dividend for every single BDC five years out. A bit like what Casey is saying about peak earnings, we don't think we're at peak dividends, obviously because they're related. But even before we get to 2024 or whenever interest rates are going, we think there's still room for more dividend growth. Not huge dividend growth. But in a relative world where everything else seems to be dropping in terms of yield, BDCs are holding or growing, I think that makes it very attractive compared to leverage loans, or high yield bonds, or many other income investments is one of the reasons that we like it as an investor. And so many investors are in the business, it's because of the dividend, and that moment is a pretty picture.

John Cole Scott: I know you do a lot of work with NAV trends, the way I kind of showed quickly on that intro session about generally speaking no BDC is the same. But you must have relatively stable or growing NAV to have in theory a relatively stable or growing dividend because the math is connected at the accounting level.

Nicholas Marshi: Yeah, we've had six quarters of growing NAV. And so as you say, they're a hand in glove.

John Cole Scott: They are. Casey, do you have any perspective you want to add on dividend components and your analysis? I might even add, if you're talking to management, whether you recommend raising the dividend on a quarterly basis or a special as how it will benefit investors relationship to the stock price?

Casey Alexander: [inaudible] I was on a panel about six years ago for IG Global, a BDC panel with the chief financial officer of Apollo, with Kipp deVeer from Ares, and with another prominent gentleman in the BDC industry. And I proposed at that point in time that BDCs given their proclivity to invest in floating rate assets, that a variable dividend structure was the structure that would make the most sense, that would allow managers to operate BDCs on the basis of trying to earn a total return. At that time they looked at me as if I had six heads and that was not a well-received thought.

Now you have dozens of BDCs that have set a base dividend with special distributions, and in effect [inaudible] a variable dividend under another name. And so that has become more prevalent because it's extremely important for BDCs to make sure that they actually underpay their earnings a little bit so that they make a reserve for credit issues down the road. [inaudible] This is how dividends can increase, and NAV can increase in a more measured fashion. And it's been our experience that those BDCs that are both increasing NAV and increasing dividends are generally the best performers long term. So we think that is an important consideration.

John Cole Scott: Got it, thank you for that. Again, I'm changing the order from the plant but you're doing wonderful. As I told you on the prep call, if you'd prepared too much I'd have picked the wrong people to be here with me. But I'm going to throw this next one to Mitch. And so Mitch, let's think about leverage. Where are we in historical leverage levels, taking the new leverage rules, I think 18 months old maybe, into account? Where do you see leverage going? How do you see people choosing to add leverage? What should be that leverage analysis we use as investors in the space based on your experience?

Mitchel Penn: I think right now we're around one times leverage, and the reason is that BDCs have generated lots of gains this year and prepayment speeds have been high. BDCs have not needed to increase leverage to generate additional earnings. So I'm going to actually comment a little bit about the previous question because I have some thoughts on peak earnings.

John Cole Scott: Okay. Your time.

Mitchel Penn: So we look at ROE, or earnings. And that's not just NII, it includes unrealized and realized gains and losses. Year to date ROE, for the BDCs we cover, and we cover over 30 names in the group, are around 17-18%. That's one of the best years ever. If you go back to '04-05, there were four or five BDCs back then and you had some were a little higher because Main and TCAP had some high numbers those years. But in general, 17% is pretty good.

So we agree with Casey and Nick that the dividends are likely to go up, the NII is likely to go up as interest rates rise. But we're not so sure about the unrealized and realized gains and losses. We don't think that you're going to see the types of gains we've seen this year. And so you may see a base NII of let's say 9% grow to 11% or 12%, but we don't think you'll get to the 17%. And we think that even in a higher rate environment you could see equity values and warrants that are in these portfolios, be under some pressure. So we're not as confident, we think we may have seen peak earnings this year.

John Cole Scott: You're allowed to disagree.

Casey Alexander: Yeah, John, let me just answer to that. That when I'm talking about peak earnings I am talking about NII, I'm not talking about earnings per share. And simply the reason that I'm talking about NII is that's generally what the BDCs dividends are based off of, is their net investment income earning capacity. And I would agree with Mitch that this has been a unique year for harvesting some capital gains. On a net earnings basis, Mitch is probably right.

John Cole Scott: Okay, very friendly panel.

Mitchel Penn: Well, it's funny because, and I think this points out all the nuances of covering BDCs, you have BDCs present information in the best possible light. And guys like Nick and Casey and I, we're trying to sift through a lot of the noise so that you understand what is really going on. And a good example is there are a lot of BDCs when they quote ROE base it on NII, and they exclude gains and losses. You're a lender, right? How can you exclude gains and losses? That's ridiculous. And so it just points out that there are nuances to this, and that's why there are opportunities.

John Cole Scott: I'm pulling a question for Nick, and at this moment I'll say we had one question pop up organically. If you're in the audience and have a question, we have carved out time for that. I'm doing my job keeping us on pace. But for Nicholas, how do you think of the different uses of the non-loan parts of BDC portfolios? So this is a chance to consider the different equity exposures across the landscape. And then thinking about Saratoga being on the next panel, they have a CLO business that they use. How do you think of anything beyond loans at the BDC level and how it should be considered by investors?

Nicholas Marshi: I think this is one of the lovely features of BDCs compared to some other closed-end funds. They have this ability to go and invest in virtually anything that you can dream of. Venture debt and loans are just the beginning, and then there's CLO equity [inaudible], but there's also real estate. There is Ginny Mae investments being done over at Barings, and lots of lots of equity and warrants in smaller large companies. The beauty of those is that it gives the opportunity for the BDCs who do it right, to not just have their NAV over time eroded through inevitable credit losses. But actually make some money and offset or more than offset their credit losses and create an increasing net asset value over time, which is obviously generally a good thing.

The tradeoff of course is that if you've got money in an equity investment, it could sit around for seven years and earn you nothing in terms of income. And that's always the tradeoff. But when done right, as Gladstone Investment has been doing recently, and FIDES, and Capital Southwest and so many others, and Ares for that matter. And Saratoga, sorry Saratoga. It can really show up in higher earnings, higher dividends, and higher net book value, so I think it's a good thing.

Mitchel Penn: Hey, John?

John Cole Scott: Yes, sir.

Mitchel Penn: The key to that is really using the proper discount rate, right? So what Nick's described is risk. So when we look at BDCs, and just using an analogy, think about bonds. Some BDCs are A rated bonds and some BDCs are BB bonds. It's just a matter of what's in the portfolio. And as BDCs put more equity in their portfolio, they're riskier. I'm not saying that's good or bad, because risk can be really good as the economy is expanding, you get paid for that. But the point is that BDC portfolios are different and have different risk profiles. We account for that difference in risk by assigning each BDC its own discount rate.

John Cole Scott: Good point. Very good point, I always love your follow-ups. So for Casey, and kind of wrapping this panel as I see the time, the thing that we've touched on but I'd really like to have you focus on, the two things that are squarely in the news cycle; inflation and rising rates. But to be fair, for the seven years I've had my BDC UIT, I've built it for rising rates and we've seen very little of it. A couple of sprints but then retreat. So as a BDC investor, whether you're established or new, I see the audience, I see a mix of both. How should you be thinking about inflation and rate changes as you build your current portfolio? And I'll even give you a little bit longer question, what should you be planning for in the inevitable next change and the unexpected, usually downside, of BDCs?

Casey Alexander: We do think it's early in that conversation. In 2019 when the yield curve actually inverted, we became extremely conservative on BDCs. And I covered 16 or 17 BDCs, and we were down to three that we were recommending at that point in time. Now there may be three that I'm not recommending because I believe that we have a bull market in credit performance as well as a bull market in yield solutions. And both of those are impacting BDCs in a favorable way.

As it relates to inflation and interest rates, I think we've already talked about the interest rate hedge that BDCs have built into their earnings structure. It's interesting what happens. When there are spikes interest rates BDCs actually sell off because they are yield instruments and yield instruments act inversely to changes in interest rates. But then ideally down the road as their operations improve, we would expect that performance of the share price improve as the earnings reflect the change in interest rate earned in the portfolio.

Inflation, something that we haven't dealt with in a major way since I'd say the 70s. That's going to be a learning experience for all of us. What I think we will find is that each BDC will experience it differently based upon the composition of its portfolio and how that composition is necessarily directly impacted by inflation. And so that's going to be a learning experience even for those of us who've been watching BDCs for a long time.

John Cole Scott: Very good. Any thoughtful follow-up on that from anyone?

Mitchel Penn: Yeah, I agree with Casey. This is uncharted territory. I've asked all the BDCs for the last two quarters for thoughts on inflation and you really don't get a consistent opinion. What I will say, it's clear that the supply chain disruption is impacting BDCs today. It's not in a major way, but they're talking about it. And so when they're talking about it means it's real. And so the question is, does that sort of subside? Was it just a temporary blip as people get back to work and they fix this issue or does it become extended? The more it extends, the higher the probability inflation has some legs.

Nicholas Marshi: I have one little thing there to add, just very briefly. I write the *BDC Credit Reporter* and I follow all the latest in nonaccruals and companies getting into trouble. Obviously it's a very, very low level at the moment. But there have been several BDCs reporting one or two new nonaccruals that have popped up just in this last quarter. There's a trend, and there's not enough really data for a trend. It's because there's the leftover impact of Covid, not everybody has recovered from Covid. Maybe they were weak before or maybe they're still involved in it in some way. And then logistic issues have caused a couple of companies to get into trouble. So if this goes on, which I don't really think it will, but if it does go on there could be some increase in non-performing loans. But in the overall scheme of things it's still tiny given there's so many other positive trends that are helping companies and BDCs move forward.

John Cole Scott: Good perspective there. There was another question that popped up, it should be simple. Would you classify BDCs as lenders or investors?

Mitchel Penn: Both. They're lenders first and then they get a piece. The equity is relatively small. GAIN would be the only one you might classify as an investor, because they buy the whole company and then they use inter-company debt to deal with it. But they're buying the whole company, they look more like a private equity firm.

John Cole Scott: Kind of like the soon to leave the sector, Newtek, which is just another complicated BDC that's about to go off our radar.

Casey Alexander: And lending to a company is simply another way of investing in their capital structure. So the answer to that is both.

Nicholas Marshi: Yeah, I think what's interesting is that with so many BDCs now a part of big asset managers that are used to doing everything. And so they start out as a lender, but they remind the companies they're lending to and they remind their investors, that if they need to they'll become the investor and run the show. And we see that across many BDCs both large and small. And I think it's actually one of the strengths of most BDCs, is that they don't have to adjust when something goes wrong. Write off the loan and talk to their regulators about it as banks do, or did. But they can take a longer term view and they can restructure a company. They have plenty of money to throw at it. And something that's a dog today can be a big winner in three years' time.

Casey Alexander: I think Mitch would agree that we've seen dozens of presentations where BDCs say, "We take a PE approach to credit." So they're starting from an equity standpoint because those deals are coming to them from a private equity sponsor. So that's the first analysis that they see, is the analysis driven by an equity investor prior to them making a debt investment.

Mitchel Penn: Yeah, I would agree with Casey. When you run a downside scenario as a lender, the ultimate is you're going to take over the business. So you're always looking to say, "Are you willing to live with this business if all hell breaks loose?" So yeah, they look at it that way.

John Cole Scott: And I'm sure I know on the next panel, one of Saratoga's story is the Reddy Ice, everyone typically knows about it. But I'm sure there's a bad version of that story too for other BDCs where they took over and it wasn't a big success.

I was always worried about the time, you guys were wonderful. It was a pleasure to have all three of your perspectives for our audience. Again, this is recorded, we'll be transcribing it. You can approve and add disclosures as needed to make this as useable and durable as possible for our replay audience and the rest of the world after. But I could not thank you each enough for being so different yet successful in your time with us today. Please feel free to stick around to ask some good questions of the next panel if your schedule allows. But it's earnings season still, so if not, I do understand.

So with that I'm going to take us back to the floor. The next session will start at 2:30, so you have about a 12 minute break to mingle, or to grab a cup of coffee, or take any other break that's needed for your schedule today. Thank you.
Recorded on November 17, 2021.

Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/

Oppenheimer Disclosure:

This report is issued and approved for distribution by Oppenheimer & Co. Inc. Oppenheimer & Co. Inc. transacts business on all principal exchanges and is a member of SIPC. This report is provided, for informational purposes only, to institutional and retail investor clients of Oppenheimer & Co. Inc. and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. The securities mentioned in this report may not be suitable for all types of investors. This report does not take into account the investment objectives, financial situation or specific needs of any particular client of Oppenheimer & Co. Inc. Recipients should consider this report as only a single factor in making an investment decision and should not rely solely on investment recommendations contained herein, if any, as a substitution for the exercise of independent judgment of the merits and risks of investments. The analyst writing the report is not a person or company with actual, implied or apparent authority to act on behalf of any issuer mentioned in the report. Before making an investment decision with respect to any security recommended in this report, the recipient should consider whether such recommendation is appropriate given the recipient's particular investment needs, objectives and financial circumstances. We recommend that investors independently evaluate particular investments and strategies, and encourage investors to seek the advice of a financial advisor. Oppenheimer & Co. Inc. will not treat non-client recipients as its clients solely by virtue of their receiving this report. Past performance is not a guarantee of future results, and no representation or warranty, express or implied, is made regarding future performance of any security mentioned in this report. The price of the securities mentioned in this report and the income they produce may fluctuate and/or be adversely affected by exchange rates, and investors may realize losses on investments in such securities, including the loss of investment principal. Oppenheimer & Co. Inc. accepts no liability for any loss arising from the use of information contained in this report, except to the extent that liability may arise under specific statutes or regulations applicable to Oppenheimer & Co. Inc. All information, opinions and statistical data contained in this report were obtained or derived from public sources believed to be reliable, but Oppenheimer & Co. Inc. does not represent that any such information, opinion or statistical data is accurate or complete (with the exception of information contained in the Important Disclosures section of this report provided by Oppenheimer & Co. Inc. or individual research analysts), and they should not be relied upon as such. All estimates, opinions and recommendations expressed herein constitute judgments as of the date of this report and are subject to change without notice. Nothing in this report constitutes legal, accounting or tax advice. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice on the tax consequences of investments. As with any investment having potential tax implications, clients should consult with their own independent tax adviser. This report may provide addresses of, or contain hyperlinks to, Internet web sites. Oppenheimer & Co. Inc. has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

This research is distributed in the UK and elsewhere throughout Europe, as third party research by Oppenheimer Europe Ltd, which is authorized and regulated by the Financial Conduct Authority (FCA). This research is for information purposes only and is not to be construed as a solicitation or an offer to purchase or sell investments or related financial instruments. This research is for distribution only to persons who are eligible counterparties or professional clients. It is not intended to be distributed or passed on, directly or indirectly, to any other class of persons. In particular, this material is not for *distribution to, and should not be relied upon by, retail clients, as defined under the rules of the FCA. Neither the FCA's protection rules nor compensation scheme may be applied. https://opco2.bluematrix.com/sellside/MAR.action*

Distribution in Hong Kong: *This report is prepared for professional investors and is being distributed in Hong Kong by Oppenheimer Investments Asia Limited (OIAL) to persons whose business involves the acquisition, disposal or holding of securities, whether as principal or agent. OIAL, an affiliate of Oppenheimer & Co. Inc., is regulated by the Securities and Futures Commission for the conduct of dealing in securities and advising on securities. For professional investors in Hong Kong, please contact researchasia@opco.com for all matters and queries relating to this report.*

AICA Disclosure: *The opinions of the speakers / presenters are their own opinions and may not be the opinions of AICA. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Nonlisted closed-end funds and business development companies do not offer 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 increases 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.*