How To Size Up BDCs To Determine The Standout Buys

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mitchel Penn, managing director of equity research for Oppenheimer and Co. Read the Q & A below as Mitchel talks about the challenges of analyzing and evaluating business-development companies, and then highlights Runway Growth Finance Corp. – which his firm expects to outperform the market and competition – to show the methodology in action and to showcase the place BDCs should occupy in diversified investment portfolios.

Mitchel Penn

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

CHUCK JAFFE: Mitchel Penn, managing director of equity research for Oppenheimer and Co. is here and we're talking about how to analyze and size up a business-development company now on The NAVigator. This is 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 heading in the direction of business-development companies with some help from Mitchel Penn, managing director of equity research for Oppenheimer and Co. which is online at Oppenheimer.com. And we're going to discuss the firm's decision-making process when it comes to BDCs, and you're in for a treat because we're also going to dig in on one BDC that has come through that analysis process looking good. Before we jump in, a reminder to learn more about business-development companies, interval funds, and closed-end funds, you can go to AICAlliance.org, the website for the Active Investment Company Alliance. Mitchel Penn, welcome to The NAVigator.

MITCHEL PENN: Thanks Chuck, I'm glad to be here.

CHUCK JAFFE: Mitchel, every type of investment can be at a challenge to size up properly. I mean, that's why we have pricing disagreements that create the market in general. But business-development companies most assuredly present some unique challenges, so help us understand what those are and let's dig into the research process that you use at Oppenheimer.

MITCHEL PENN: Great, Chuck. So what we find is stocks trade on earnings, so what we do is we spend a lot of time trying to understand how a company generates earnings, and specifically for a BDC, they're a lender to small-medium sized private companies, so we're really trying to dig in and understand how they generate these earnings year in and year out. And the best way to do that is take an example, and we've chosen Runway Growth Finance, it's a BDC that focuses on late-stage venture growth companies. And I think as we go through how we evaluate Runway, your audience will get a better understanding of how we value BDCs and evaluate BDCs.

CHUCK JAFFE: Runway Growth Finance is ticker symbol RWAY. Jump in, help us understand why this is one that looks good to you.

MITCHEL PENN: Sure. First of all, let's think about who they lend to. So they lend to technology companies, life science companies, healthcare information and services. And these companies are late-stage venture, so they don't typically generate a lot of earnings, they're supported by private equity firms. So that makes them a little unique, and you'll get to see why that is. The first thing we look at when we look at a company is the return on equity, and is that return stable? So you can have one BDC that generates a 9% return on

equity since its IPO and it's fairly stable, the range is from let's say 8% to 10% year in and year out. You can also have another BDC that generates a 9% return on equity where the returns vary from negative returns to very positive returns, there's a wide range. That wide range would indicate higher risk to us, and a narrow range of returns indicates that it's a less risky company. To give you an example, Runway since first quarter of 2018, its ROE has averaged 9.6%. And I'll go through the numbers later but it's fairly stable. We estimate that they can earn $1.26 and $1.73 in '22 and '23, that equates to a return on equity of 8.6% and 11.7% respectively. We have a per-price target of $15, which is right around book, and the way we get there is we assume they can generate a 10% return on equity, and we assign a 9.5% cost of equity capital. We do rate it an outperform. Let me just give you an example of why we cost of equity capital. When we evaluate a BDC, we think of BDCs similar to the way folks think about bonds. You can buy a AAA bond that yields, let's say 3%, and you can buy a single B bond of just below investment grade that yields, let's say 7%. Those bonds are valued at, let's say $100 each, but the return profile is very different. And there's a lot more risk in that below investment-grade bond that's got that higher yield.

CHUCK JAFFE: That being the case, you've got to decide when you're looking at a BDC, just how good are they at underwriting and how strongly and how confidently can you forecast the earnings? So what about Runway stands out to you there? Or how do you analyze that with Runway or anyone?

MITCHEL PENN: Sure, so let's do this, let's start with our earnings estimates. And then we can go into how we get from one estimate to the next, and then we can go through the different components. So the first thing is we estimate $1.26 in '22 and $1.73 in '23, and that's a big jump, right? That's almost a 50 cent jump. And the reason is Runway currently has very little leverage, they're at 0.13x. And that compares to the average BDC where the leverage is 1x. So it's grossly under-leveled. And by the way, the ROE's historically since 1Q '18, they didn't have very much leverage. So the 9.6% average is really without leverage. And we believe that they're going to grow their leverage from 0.13x to over 1x leverage by the end of '23. And there are a couple reasons we think that, and basically we've had rising rates and that's likely to slow down the pre-payments. So the loans that are in their portfolio, they're likely to hold on to them a little longer. We estimate about $500 million of portfolio growth in '22 and $500 million again in '23. In order to get that growth, they're going to need to raise

debt capital by increasing its bank line or issuing bonds. And we think that's fairly possible because they've got a BBB+ rating from Egan-Jones, so we think that they should be able to raise that kind of debt.

CHUCK JAFFE: As we put all of this together, it sounds like a lot of this is science, a lot of this is let's look at the numbers and size them up, but there's a little bit of art. And the art is what makes Runway presumably an outperform in your system, so how do we mix this together to come to that?

MITCHEL PENN: Sure, so the art is we look at what they've earned in the past. So they've earned that 9.6% ROE in the past without leverage. We look at the current portfolio yield, which is 14%, which would support our estimate of a 10% ROE. We look at the portfolio, the portfolio is 85% first lien, so it's very high quality. We look at the credit rating, the BBB+ from Egan-Jones, and then the belief that they can increase leverage. So we do think that's how they get the ROE. We also have to figure out, well, what's the cost of equity capital? How risky is this BDC? And we use a cost of equity capital of 9.5%, the average BDC is at 9%. We use a 9.5% because they're in the venture debt space. These companies don't have earnings and they're supported by their private equity sponsors. The interesting fact here is that the typical venture debt BDC makes a loan at a relatively low loan-to-value. In the case of Runway it's 15.7%. Moody's and S&P have looked at LTVs for venture debt BDCs in the past, and they've noted that they've been around 20%, so Runway's a little bit better. And I think that's a just remnant of the strong IPO market we've had over the last couple of years and that's why the LTV is much lower. One of the things that people look at is where the company's latest round, so the borrower's latest round of financing gives you a pretty good sense of what the value is. So if we use that 9.5% cost of equity capital, we use a 10% forecasted ROE, that allows us to get to that $15 estimated price target.

CHUCK JAFFE: Again, doing all that with a really solid yield, a good return on equity, all those other things, it's Runway Growth Finance Corp., RWAY, a business-development company. We now know more about it and we know about the process, really interesting. Mitchel Penn, thanks so much for joining me on The NAVigator to talk about it.

MITCHEL PENN: Thank you.

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