BDC Reporter's Marshi Is 'Quite Optimistic', Even If There's A Recession

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Nicholas Marshi, editor of the BDC Reporter. Read the Q & A below as Nicholas says that business-development companies had a good first-quarter across the board, despite troubles across the broad market. After seven quarters of BDC's generally increasing net asset value per share, and while that growth decelerated during the first three months of 2022, Marshi says it was a "hinge quarter," where inflation, higher interest rates, and more started to creep into results. He notes that business-development companies are poised to benefit from higher interest rates without suffering significantly higher credit losses in the process; as a result, he's bullish on BDCs now, even in the face of an economic slowdown.

Nicholas Marshi

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

CHUCK JAFFE: Nicholas Marshi, editor of the *BDC Reporter* is here, and we're talking about how business-development companies have been performing in this year's topsy turvy markets. Welcome to 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's 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 looking in the direction of business-development companies with Nicholas Marshi, editor of the *BDC Reporter*, a daily online publication covering all developments in the BDC sector, and you can learn all about it by going to BDCReporter.com. And while you're learning, well, you can get a lot more knowledge about BDCs, and interval funds, and closed-end funds at AICAlliance.org, the website for the Active Investment Company Alliance. Nicholas Marshi, thanks for joining me on The NAVigator.

NICHOLAS MARSHI: Hi Chuck, great to be here.

CHUCK JAFFE: Nicholas, we've gotten through the first quarter and it has been a heck of a year in every investment category, but BDCs have actually had a really interesting time this year. So let's take a step back and talk about earnings season and then maybe a couple of highlights from it.

NICHOLAS MARSHI: Yes, we've just finished earnings season, and the *BDC Reporter* tracks all the public BDC companies, and there are 44 at the moment, and just this week we had the last one from Capital Southwest. And despite all of the trouble in the broader market, the first quarter of BDC results have really been very good almost across the board, and this follows seven quarters of BDCs generally increasing their net asset value per share. This quarter, that growth decelerated a little bit, but otherwise the results were very good.

CHUCK JAFFE: The results were very good, but how do you feel the results are going to be moving forward? What are we looking at for the BDC sector as we move well into second, but the rest of the year?

NICHOLAS MARSHI: This really was a hinge quarter, and that's what I'd like our listeners to focus on. We've come out of seven quarters, as I said, of very good results for BDCs where they've been increasing their net asset value per share, they've been raising their dividends, most of them have been increasing their earnings, but this is the quarter that we got the fast inflation, we've got the Ukraine war. None of that's really reflected very much in the first quarter results. The next several quarters are going to be very different with the economy slowing down and with many people saying there's going to be a recession. So I think the question is, what do the latest numbers tell us about the outlook for BDCs going forward? And I've got to tell you, and this is not a word that's often used about me, I'm quite optimistic, even if we get a recession in 2023.

CHUCK JAFFE: Let's talk about where BDCs are in terms of as you were digging into the earnings reports, what are you looking at in terms of the general strength of balance sheets and all that? Are BDCs well positioned to weather what comes next? Because obviously interest rate conditions changing is central to the existence and fortunes of BDCs.

NICHOLAS MARSHI: It's a great irony what's going to happen in the future. Rates are going to go up, and higher rates if they move up high enough, by definition the Fed is trying to cause the economy to slow down, and slow down often results in companies are not performing well and defaulting on their debt. Obviously that's bad for BDCs, and that's why you see some investors running for the exit. Yet at the same time, higher rates is good for BDCs because BDCs charge their borrowers based on floating rates, and so every BDC on the listener's conference call has been pointing out on paper that if the Fed raises rates by 100 or 200 basis points, they'll be making anywhere from 10% to 30% higher earnings on a proforma basis than they did before. So we have a race that we're looking forward to in 2023, between any income lost to credit losses, compared to higher income gained from all the loans that have continued to perform and will be paying more interest to the shareholders of the BDC.

CHUCK JAFFE: So you're saying that if higher rates bring increased credit risk, which is by the way typically what happens when we get higher rates, that you're not worried about BDCs being burned by defaults. They've got better income coming in because of the higher rates to offset potential defaults and everybody's solid enough that you're not expecting some wave or big problem?

NICHOLAS MARSHI: Exactly, and what we also found in this first quarter's results, most BDCs give us an investment rating of their portfolio, and they tell us what their non-accruals are and other useful information so we can get an idea of their credit picture. And overall there are like 4,000 different companies that BDCs own. This quarter there were only eight new non-accruals over 44 BDCs and 4,000 companies, which is a very low number of new non-accruals. And of those BDCs that provided ratings, most of them have a very low, based on the historical standards, percentage of underperforming assets. So the BDCs are going into this recession that everybody says is coming around the corner, with their best results from a credit point of view in a long time. And just a quick thing to add to that, and the managers can also see this potential recession coming, and so they've been getting their balance sheets ready and getting their liquidity up, and raising debt at very low rates on an unsecured basis. And so they're very well positioned to take whatever storm might be coming.

CHUCK JAFFE: And in terms of any potential storm that might be coming, one concern that maybe people don't think about if they're relatively new to BDCs is liquidity. Is liquidity a potential storm for you? Do we have potential liquidity problems?

NICHOLAS MARSHI: Liquidity is often a problem when you get a storm right out of nowhere in a very short period. Because everybody's just running along thing that things are going to be better and better, and then suddenly we have a Lehman or we have a European financial crisis or we have a pandemic most recently. And back in 2020, a lot of BDCs were caught flatfooted by the pandemic and they had to raise money on very unfavorable terms because they have over-leveraged themselves and had various other problems. This time, because we've been hearing nothing but "recession" for months and months and months, the BDCs are very well ready for anything. They've got lost of unused lines, they've got cash, some of them have sold off a few equity positions which has given them more cash, and so virtually every BDC is sitting there with lots of liquidity and that's very reassuring for investors.

CHUCK JAFFE: As you look ahead, there's a lot of talk about what the market is capable of for the rest of this year and whether we could see a rally. A lot of people expect that we see a rally and then we'll get the recession. Would we expect that going forward BDCs will ride a little bit more with the market than they have thus far? Because thus far they've been a bit counter to the trend. Or are they going to be a safe haven and a much better safe haven in the big storm that might be coming?

NICHOLAS MARSHI: That is really the $64,000 question. Historically, and I've been investing and writing about this for the last 20 to 30 years, when there's a recession investors in BDCs tend to run for the door, even before they know how bad it's going to be. On the assumption that, and not an incorrect one, that with recessions come big credit losses. For example, in the Great Recession BDC prices dropped in some cases 80-90%, partly because of the Lehman collapse. And we're not likely to get that this time, but there is danger that. However well BDCs are doing, that the fear of a recession, if it really starts to bite, will cause them to drop. But then they tend to bounce back very quickly once everyone's worked out just how bad the picture is. And I don't think the picture's going to be very bad, so I don't think we'll drop as low as we have in past recessions, but it's certainly something to worry about.

CHUCK JAFFE: Well, you help ease our worries. Nicholas Marshi, thanks so much for joining me on The NAVigator.

NICHOLAS MARSHI: It's been a pleasure.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, you can check out my hour-long weekday podcast on your favorite podcast app or by going to MoneyLifeShow.com. To learn more generally about business-development companies, interval funds, and closed-end funds go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Nicholas Marshi, he's editor at the *BDC Reporter*, which covers the BDC sector from soup to nuts online at BDCReporter.com and on Twitter @BDCReporter. The NAVigator podcast is new every Friday, ensure you don't miss anything by following us on your favorite podcast app. And until we do this again next week, happy investing everybody.

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