Oppenheimer’s Penn: BDC Payouts Have Improved, But Credit Risk Is Up Too

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mitchel Penn, managing director of equity research at Oppenheimer & Co. Read the Q&A below as Mitchel says that business-development companies have seen yields rising in line with higher interest rates, a trend he sees continuing while the Federal Reserve continues hiking rates. The higher rates have resulted in more credit risk with more borrowers struggling to make payments; as a result, unrealized losses at BDCs have increased, and while those setbacks remain within expected ranges this year, investors will want to watch the trend to make sure losses don't grow wildly if rates keep rising and/or remain high for several years.

Mitchel Penn

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

The market has everyone’s accounts out of line, boot camp can help get them back on the straight and narrow. The Active Investment Company Alliance is holding its Closed-End Fund/Business-Development Company/Interval Fund BootCamp and Roundtable in New York on November 16th. It’s a chance to meet and hear from the best and brightest minds in closed-end fund investing today, and advisors can earn eight confirmed continuing education credits. Get more information at AICAlliance.org; use the code AICAVIP30 to get 30% off your registration. See you there.

CHUCK JAFFE: Mitchel Penn, managing director of equity research at Oppenheimer & Co. is here and we're talking about business-development companies and how their landscape is changing in today's rising interest rate environment, 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 taking a measure of the market for business-development companies with Mitchel Penn, managing director of equity research at Oppenheimer & Co., which you can learn about at Oppenheimer.com. You can also learn more about business-development companies, interval funds, and closed-end funds at AICAlliance.org, the website for the Active Investment Company Alliance. Mitchel Penn, it's great to have you back on The NAVigator.

MITCHEL PENN: Thanks so much, Chuck.

CHUCK JAFFE: Business-development companies, I don't think that people who are not really familiar think about them the same way they do necessarily all financial companies. But when you have a rising rate environment and a high inflation environment, you've got really interesting conditions for companies in the financial space, and these are conditions that most assuredly are impacting BDCs. So let's talk a little bit about rates and start with what's been going on with BDCs as they have responded to the Fed, and what you think's going to happen as the Fed continues raising rates in the next three, six, nine months.

MITCHEL PENN: Sure. Now so BDCs have floating-rate loans, so as rates rise, the income on their portfolio rises, and what's really interesting is we estimate that BDCs in the last quarter increased their yield on their portfolio by 90 basis points. In fact, our data shows that for 26 BDCs that have already reported this quarter, that interest income has risen 90 basis points to 7.3%. And based on the Fed's comments, interest rates are likely to continue to go up over the next three to nine months, so we think that income at BDCs will continue to rise. And the nice thing is this is recurring income, so they're getting this every quarter. And the interesting thing is high rates also has a negative, and the negative is credit risk, right? Because as rates rise, their borrowers have to pay more interest and their interest coverage ratios decline, so what we've seen is unrealized losses at BDCs have increased. And what's really interesting is that those losses average 3.5% on an annualized basis year-to-date, or 2.6% actual through three quarters. What we like to do is compare that to what we expect to see for losses this cycle. We estimate between 1-6% losses this cycle, and we get there because we look to the rating agencies, and they actually estimate 4-5% defaults this cycle, and if you assume a 50% recovery on those defaults, that equates to a 2-2.5% loss. And what's really interesting is you compare that to what the BDCs have already taken, remember they've taken 2.6% actual losses through the first three quarters, they've already booked the full loss for the cycle. That's what I think investors have missed.

CHUCK JAFFE: Default rates, not just in BDCs, everywhere, like if you're looking at junk bonds, junk bonds haven't been junky for a long time. And although everybody has been worrying about it and talking the right things as we've watched rates go up, everybody's also kind of said, "Yeah, but I don't think it's going to be a big deal." But these numbers that you're kicking out, and some other things that I've read about the BDC space, it's scary. And yes, you can plan for it, but we've gone to kind of the limits of what folks were expecting really quickly, haven't we?

MITCHEL PENN: BDCs, they mark to market their portfolio each quarter, so you're actually front-loading the losses, and that's very different than what you see at banks, banks book reserves. So the nice thing about when you invest in a BDC is you're getting those marks up front, and as the losses are realized, they're realized over time, they just basically reverse the unrealized loss you already took. So a good example, if we go back to 2008, the average BDC, because it was a deep recession, had about a 10% loss, and they took that as unrealized in year one, and then realized it over the next five years. The impact to NAV is neutral because all they're doing is going from an unrealized loss to a realized loss.

CHUCK JAFFE: The worry that an investor might have however would be you've got these potential losses, what does that do for liquidity? So how's the liquidity picture for BDCs right now?

MITCHEL PENN: Sure, that's a great question, and liquidity in 2020 was a really big deal, and I think BDCs really learned a lot from 2020. What we saw is BDCs that had unsecured debt fared much better than BDCs that had used secured debt such as bank lines or CLO debt to finance their portfolios. And in '21 and '22 we have a seen a lot of BDCs issue unsecured debt and layer in a lot of excess liquidity through, so what happens is they issue the unsecured debt and they pay down the bank lines so it gives them more room on their bank lines to deal with a recession or a slowdown.

CHUCK JAFFE: How do you, as somebody's who's investing using BDCs, how do you account for this? Given that liquidity worries might be up in these kind of conditions are you diversifying more? Are you doing something different?

MITCHEL PENN: Yeah, so what we do, and I think you're right, there's a lot of uncertainty still. So what we say to folks is it's better to have a basket of BDCs, and the other thing you can do is you can buy BDC debt. BDC debt yields anywhere between 7-9% and it has a five-year maturity, and because a lot of this debt was issued a year ago, it's now four-year. So for folks who are risk-averse, that's a really good alternative, and then for folks who want a little bit more return you can look at the equity for BDCs. Two of the names we've encouraged folks to look at are Owl Rock and Golub, ORCC and GBDC are their tickers, and they both trade around 86% of book. And what we look at is their historic loss rates, so we want to invest in folks that have good credit underwriting, and on a trailing five-year loss rate basis Owl Rock generated just 16 basis points of loss and Golub was 35 basis points of loss. And that compares to 83 for the group, so they're well below the group average in losses and both will likely benefit from rising rates with that floating-rate portfolio. Both trade around $13 a share and we estimate values around $15 a share.

CHUCK JAFFE: Those are good values and again they're a part of an arena, an investment world that has some interesting values and interesting things going on right now in BDCs. Mitchel Penn, this has been great, thanks so much for joining me on The NAVigator.

MITCHEL PENN: Thank you.

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, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more 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. And remember, AICA's Closed-End Fund/BDC/Interval Fund Boot Camp is Wednesday, November 16th in New York City. I'll be there, come up and introduce yourself and tell me you listen to The NAVigator, let's have a chat. Thanks to my guest Mitchel Penn, managing director of equity research for Oppenheimer & Co., learn about the firm online at Oppenheimer.com. 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, unless we see you at the boot camp, happy investing everybody. We'd love to see you at the boot camp.

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