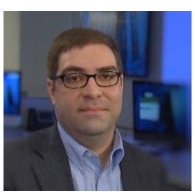
November 2022 Live Event-AICA Fall CEF/BDC/Interval Fund Bootcamp and Roundtable Panel #3; “Tips & Tricks for Accessing a Quality Manager and BDC”

Wednesday, November 16, 2022

Dan Silver, Portfolio Manager with Closed-End Fund Advisors, moderates the third panel of the AICA November 16th, 2022 live event; “Tips & Tricks for Accessing a Quality Manager and BDC”. Read the transcript below to hear the discussion among Mr. Silver and panelists Mitchel Penn, Managing Director of Equity Research and CFA with Oppenheimer, John Cole Scott, CIO at Closed-End Fund Advisors and Founder of CEFData.com, and Jorge Solares-Parkhurst, Managing Director at JMP Securities.



Dan Silver

Mitchel Penn

John Cole Scott

Jorge Solares-Parkhurst

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Dan Silver: Okay, let’s get this started. Welcome to today’s BDC panel. I think why don’t we kick it off just by each, since the panelists have diverse backgrounds, why don’t you guys introduce yourself, what firm you’re with and a brief bio/background?

Jorge Solares: Great, good morning, everyone. Jorge Solares, I’m a managing director at JMP Securities, covering financial services companies on the investment banking side. I spent the last 24 years of my career covering commercial finance including BDCs.

Mitchel Penn: I'm Mitchel Penn, I'm from Oppenheimer. I'm a managing director, I cover BDCs. Most of my career has been on the buy side, so I ran fixed-income portfolios at ETNA in the eighties and nineties, and ran fixed income at Legg Mason, and then moved over to equities and worked with Bill Miller for about 12-13 years, ran the FIG group.

John Cole Scott: I want to introduce myself for the BDC side, so we started BDC coverage in our data business in 2014 at Closed-End Fund Advisors and CEFData.com, and then we added a partnership with a UIT sponsor SmartTrust in Parsippany, New Jersey with a UIT of BDCs. Currently in series 26 with 13 names, available for advisors purchase or individuals as well. And then our data business now this year has grown dramatically to cover all non-listed BDC data, so we now have full listed and non-listed data, deeply, broadly in the space. And then we put BDCs at Closed-End Fund Advisors into our income-focused portfolios as part of a sector of closed-end funds. That's not a perfect analogy, I call them cousins than sisters but we use them as a way to diversify yield and to add value to our clients.

Dan Silver: Okay. Well, I think, Mitch, since you are a sell-side analyst covering a ton of names, why don't we kick it off? I guess the first question is, how would you summarize what we've seen year to date, but also third quarter earnings since you're in the deep of it?

Mitchel Penn: Sure. So I would say that the most interesting thing about BDCs this year has been the jump in their yields, so from second quarter to third quarter we've seen about 90 basis points of expansion in their NII margin and that's driven some of the dividend increases folks have seen. And you really haven't seen that much in credit, although year to date, what's really interesting is BDCs have taken about 250 basis points of credit losses, two thirds are unrealized, one third's realized. It gives you a sense that they're sort of banking, that's the way you bank these credit losses for the inevitable losses that you'll see.

My guess along with some of the panelists earlier, is that you'll start to see these losses emerge next year and the year after. Our best guess is we just look at Moody's and S&P, they're sort of 4-5% defaults. When I speak to the BDCs they're saying that's pretty consistent with what they're seeing. And probably if you figure 4-5% defaults, let's say 50% recoveries, that's 2-2.5% losses, and that's not very much because you just gained 90 basis points in a quarter. You're probably going to gain another 90 in the next couple of quarters, so now you're closer to 200 extra basis points on your portfolio and you're only talking about 2% losses. Remember, this income's recurring, the losses that we're talking about is one time through a cycle. So we think that there's some real opportunities for BDCs.

Dan Silver: I would say, Jorge, is there anything you want to tack on? Obviously you have a different perspective. Anything notable from the last quarter or two?

Jorge Solares: Yeah, I think it's interesting what Mitch brings up. I think the only thing that I would have a question for Mitch, is how he views leverage. Because leverage has also increased across the sector, and I think it's going to potentially. It's very hard with the kind of leverage that you have in the BDC space to really blow yourself up, but as we were talking about, Dan, last night, given how much more leverage the BDCs have put on in recent years, I do think it starts complicating matters with their lenders.

They have a lot of covenants now that maybe they didn't have before. They have a revolver. A lot of them have been doing institutional private debt placements which have covenants. So it's not like before where they have baby bonds, have no covenants, you can do whatever you want, you could subordinate them as far down the capital stack as you possible could. And I think that's changed.

And so whereas Mitch and I have both covered commercial banks before, and there where you have a 2% loss, that's magnified through leverage quite a bit, here it might really be like 5% of NAV. And that's a lot better but I think things have changed. I don't know if you agree with that, Mitch.

Mitchel Penn: No, I would agree. So what happened, I think it was three or four years ago when they changed the rules, basically BDCs used to be at one times leverage. And when they were at 1x leverage, they averaged about 80% debt to equity, and then when it went to 2x, the current average is around 1.2x debt to equity for BDCs. And the magic around the 1.2x, it's what the rating agencies require for a BBB- rating. So if you're a BDC, as you point out, they need access to the capital markets, and you need an investment-grade rating and Moody's and S&P try to keep you at between 120 and 130 of debt to equity. And so I agree with that but I do think they should be able to manage through that.

I don't actually have any problems with the BDCs being restricted, because sometimes that's good, right? And you don't want the leverage to get too high because that can really hurt. I look at growth with BDCs as a two-edge sword. If you're growing and you have to grow continually, then you've got to buy every deal that comes across your desk. If you're limited on your growth you can be pickier and you can start to optimize around the current size of your business. I think TSLX does a really good job of not growing too much and optimizing around their current size, so I don't have an issue with it.

Jorge Solares: Yeah, that's actually a good point. I often point to them as Dan knows, the TSLX. Because I do think that's a perfect example of someone that has an enormous origination franchise, they have multiple vehicles that they can put any of their originations into, and they don't take the approach that many other asset managers take which is, oh, they just take a sliver of each deal and put it into each vehicle and they treat the BDC like a fund.

And I think that's where I think mistakes happen because for Sixth Street, that BDC is a separate entity, it's a company, it has a board of directors and they're very cognizant that it has their own management team and they make their own decisions. So they're leveraging the platform that Sixth Street has, formerly known as TPG, but they're not forcing the BDC to take originations that the platform has decided to make. And that makes I think a huge difference when it comes to credit quality, et cetera.

Because that management team is making decisions for that BDC in particular, taking into account their leverage, their capital structure. Their required rate of return for retail investors, the expectations that institutional investors have, rating agencies have, all of their constituents. Which are very, very different for a private fund that has none of the other considerations, much less rating agencies or the need to maintain an investment-grade rating. So I think that makes a huge difference, I'm glad you brought that up.

John Cole Scott: And then I might add, if you think about it, I came to BDCs, I was born basically owning closed-end funds, and sometimes there you sift from premium discount and sift and shop in the lower area of that market. One thing I learned, unfortunately the hard way in '14 and '15, was you often need to look much more at whether it's external versus internal as a management structure. And that most BDCs in regular markets will trade above net asset value, which adds the great ability to add a secondary offer of shares that's accretive to net asset value.

And when we look at the management teams, I don't have nearly as much experience as these two guys, that's why we're friends, is we love to see the management teams that are thoughtful and careful in how they raise their debt and their leverage, and they're really trying to keep their leverage ratio in a set range. Right now we're seeing a little bit more equity than debt being raised because we expect when we do get the recession, and again recessions always come, we just never know when, the ability in the balance sheets of these funds to work through problems and buy things at great prices.

And just thinking back to how we really look at these funds, they are a closed-ended management company, that's why they're in my ecosystem and why I enjoy them, but they're also kind of an operating company, they're a true hybrid structure. They have an earnings season. It makes it hard to schedule them at conferences because of quiet periods and earnings season, but it does really, you can't forget that they have that common stock-like feeling but a portfolio of loans. And again, as I'm sure you guys know but for our audience that are newer to BDCs, the leverage they use while higher than taxable bond funds is nothing like other structures and products in the market.

Mitchel Penn: You bring up a good point in that one of the reasons leverage has come up also recently is BDCs are seeing some of the best deals they've ever seen. So they're getting wide spreads this quarter, you've got higher yields. The CLO folks talked about it earlier. Well, the BDCs are seeing the same stuff. And they're able to get a lot more covenants because there aren't as many people bidding for those deals.

So for example, Oaktree yesterday on their call talked about how they're going to probably take leverage up close to their maximum because they see such great opportunities. I think that's really one of the things where if you see pops of leverage, just talk to the companies, see if it's an opportunity, that's a good thing.

Dan Silver: So there's two things that are kind of interesting cross currents. On the one hand we've got valuation, we've got price to NAV, however you want to define valuation and get into it. And on the other hand there's quality and fundamentals, and this is one of the things that I think a lot of investors are focused on. At what point is the valuation attractive enough that it's a buy? And the flip side is, given the uncertainty in the macro environment and potential issues with credit, is that a consideration right now or is the flight to safety, the staying higher quality the way to go? Anyone who want to?

Jorge Solares: I'll give the less educated opinion because this is not my business right now, I'm an investment banker to these companies. But I will say that, yeah, to me personally speaking, first and foremost it comes down to management, origination franchise, and their discipline overall. There's no price that I would ever buy a BDC at if I didn't have confidence in the management team's decision making. And to me decision making means when it comes to, for instance, raising capital, they have a point of view that this is a company.

It's a company that has to generate an ROE, an ROE that's appropriate for the risks that they take. And if they don't think that way in relation to risk-adjusted return and return on capital, I don't ever want to buy their stock. I don't care if they're trading at 70% of NAV, I would say, "There's a reason why." And so if they narrow the gap, it's very difficult to force these management teams, especially an externally managed structure, to sell the company.

It's not like a bank. If a bank trades below book value, or trades even at book value or just slightly above book value, they will be eaten up by somebody else and they really have no choice. BDC management teams, because of the external management structure, et cetera, and because of rules like AFFE, et cetera, it's a common nightmare to replace a bad manager. And so in my opinion, that's first and foremost. There is really, in my book, yeah, I would never buy a BDC for on price.

Mitchel Penn: I'm going to give you some metrics because I agree with what you're saying, we look at ROE. So the best way to evaluate a BDC is what's their return on equity, because that's what you as a stockholder is going to get. And we don't mean NII, so any BDCs that talk about NII, just dismiss that, that's crazy. Remember, they're lenders. You really want to understand the gains and losses on those loans, and NII excludes that, which is crazy. So we have BDCs that'll quote the ROE based on NII, that's before gains and losses, and they footnote it, they put it in the financials but it's crazy.

So first thing to do is look at ROE. And the second thing is what's their cost of equity capital? So think of a BDC as a bond, every BDC is on a spectrum, right? You can be similar to a AA bond, you can be similar to a CCC bond, it depends on what's in the portfolio. So there are BDCs that have very high equity allocations and very high allocations to second liens, over 55%. That's riskier than, we mentioned TSLX which is close to 90% first liens. It may be higher, I don't have the exact number. But the point here is you have to think about this in terms of risk.

And I talk about that because people look at dividends. We see investors call me and they go, "Well, this has a better dividend yield." I say, "Well, do you buy high-yield bonds?" "Oh no, no, I wouldn't buy a high-yield bond." "Well, why are you looking at the dividend yield? Because the higher the dividend yield is, it's likely that the risk is going to be higher, right?" And so what we do is we try to look at historically what's the return on equity? And if the BDC has a return on equity above 8%, that's pretty good. And historically, costs of equity capital, we've used around 9%, but because rates have increased you can't use 9%, right? Because interest rates rise, the cost of equity capital goes up, so we're not at 10%.

And a good check on this, and I get a lot of questions from institutional investors as to what discount rate to use and I said, "Just look at where their bonds are trading." So you can pull up a

BDC and look at their bonds, bonds are trading at 8-9%. Well, you can't have an equity discount rate at 8 or 9% if their bonds are trading there, you're likely going to be 100 to 200 basis points over on the equity discount rate.

And that's important to understand because all these BDCs are going to be earning higher rates of return because the yields are up, and you have to appropriately increase the discount rate to account for that. So it might not increase the value of the underlying firm, but focus on ROE, focus on last six years, look at it since IPO to get a sense, are these guys good at generating returns?

The other thing I'll mention is the key to ROE is credit. We've found that the differentiator is always going to be in credit. I would encourage you to track credit losses both realized and unrealized, and that'll give you a sense of who's good at underwriting and who's not good at underwriting.

John Cole Scott: I'd say as we think about it, with our UIT product, there's 13 names in there and we are thoughtful that BDCs generally are way more liquid than regular closed-end funds, but are way more volatile. So at our firm, for separate accounts we half-size them, typically 1-3%, listed closed-end funds are typically 2-6% as a general rule. And you're correct, we always look at how good are they at paying back their debt? How fair are they to shareholders? Because it's always important in listed closed-end funds but it's even more important in BDCs. Because of the movement and the fact that the net asset values, because of the private loans that are the base portfolio investment, get marked quarterly.

And so in our product we always try to overweight, at least recently, fixed leverage. We're over 60% for our weighted portfolio, and we're 91% variable loans. So our products, underlying holdings, though it didn't exist a year ago, I said every four months, has a 15% dividend growth rate on a one-year basis in dollar terms. And one of our positions, Golub doesn't announce till Monday and we don't know the future, but if every other fund pretty much has done a dividend increase and it's a well-known credit manager in the space, it's likely they'll be in line with that.

So definitely we use adjusted core NII, we use fair market value, things I've learned from you, Mitch, and ROE. But really knowing that they're very liquid and they're very inhomogeneous, so think of the muni bond market, for those of you that are institutional investors in closed-end funds, there's only so many differences in muni bond funds, but there are so many differences in BDCs. And the cool thing is, with research and diligence like a lot of the folks I see here today, you can really uncover opportunities. And it's not always a discount answer, it's a quality answer.

Mitchel Penn: One last point I want to make is if you think the discount on a BDC is really attractive, let's say that the stock's at 70% of book, my advice to you, my first call would be to the CEO and I'd ask him, "Are you buying back stock?" And if he says, depending on his answer he might say, "Oh, I can't answer that." Ask him, "At what price would you buy back stock?" Because if he or she is not willing to buy back the stock, it may not be as attractive as you think.

Jorge Solares: The flipside to that, because I am often on the receiving end of those phone calls from analysts, and I'll tell you that depending on the size of the BDC, it's always the case that the CEO, he or she will say, "Well, that doesn't make sense. Mitch has to come down to reality. It's too illiquid," blah, blah, blah. And most of the times that may be true, particularly when you're talking about smaller BDCs that do have a liquidity issue, but that's always what they'll say.

And to Mitch's point, half of the time it's not true, they just simply don't want to reduce their assets under management. And that's permanent capital, it's incredibly valuable to the investment manager, and that's not really a consideration. So I agree with Mitch, but in my mind the ROE thing, it really has to be underlined. At the end of the day, a bank, a commercial bank, they have loan-loss reserves, they have to book a loan-loss reserve because they have to model out losses. So it makes absolutely no sense to me why anybody, to Mitch's point, would ever focus on NII.

And I also to that point would never buy, I shouldn't say this maybe, being an investment banker, but I would rarely ever buy an IPO. Why? Because it's like buying into a new building here in Manhattan, you have no idea if they're going to have good maintenance five years out or three years out. You have no idea what's going to happen. It's set up, the sponsor's going to be gone, you're going to be left in that condominium and you have no idea what the maintenance is going to be like.

And so because a BDC can't book loan-loss reserves day one, and they have to do it through unrealized losses or gain, and they have to mark their book that way, that's really what's being built. It's really the combination of undistributed income that they've generated, that they either have to pay excess taxes on if they want to keep, or they have to pay out. Plus all the accumulation of unrealized losses that are going to protect your downside.

And so I agree wholeheartedly with what's been said before, which is you have to look at the total return. I think it's a lot simpler than you think. You look at the appreciation or appreciation in NAV, plus what they're paying out in operating earnings or the dividend. And the combination of those two gives you a pretty easy way to figure out whether they're making money for you or not.

Mitchel Penn: Yeah, I agree. The other mistake people make is they look at the portfolio and they try to dig in and look up the names in the portfolio. I get calls on this all the time and I go, "That portfolio's going to turnover in three years." Three to four years. Prepayments speeds, on normal times, not in these rate-rising times but in normal times, is about every three years the portfolio turns over. So everything that's in there today likely won't be in there in three years and so you just want to look at their ability to underwrite. That's why we focus on ROE and we look at track records because they tend to be sticky.

Dan Silver: So as a follow up to that, there are a few things that are coming up that I think are interesting. Investors, it's not necessarily so easy because there are many more BDCs now than there were years past. So if you don't have the length of track record, the ability to look at management and know they've been in their seat for a while, I think it becomes a little bit trickier. So you've got access to capital markets, that's one piece of it. There's the underwriting platform, their ability to just manage credit. How do you guys think about the less established and the smaller, the big versus small thing? To the extent that obviously there are some big players, and there are a lot of other ones and some new entrants.

John Cole Scott: Traditionally the players in the market, it's not their first time doing private loans. So they're doing private funds, they may be doing a non-traded or private BDC, or they've been involved in the market in that way. And so it's interesting because I'm a closed-end fund person my entire life, so many people say, "What's the MPT stats on that investment?" Or "There's no track record." Well, I can look at the firm. Is this a firm that does well in other structures?

New funds are great, because if you can get a handle on them, and we often wait till the semi-annual report for closed-end funds and the first quarterly update for BDCs, you can get ahead of the people that say, "I always wait for a year," or "I always wait for two years." There's an extra entry point and by doing your homework you can add a lot of value.

Mitchel Penn: Yeah, I would say that we've looked at this situation because there have been BDCs that get out and say, "Well, it's an advantage to be a large BDC. We have a big advantage." So we actually have data, like we have ROEs on every BDC, and there is absolutely no correlation between the size of a BDC and the return on equity. And the person who's the chairman of one of the BDCs said this, and so I called him and I said, "Can you send us your data?" "Oh, we don't have that data." I said, "What did you base it on?" "Oh, it was just the future, we think it's going to happen." And so people say stuff, always ask for the data. When somebody tells you that big BDCs are an advantage say, "Okay, show me the numbers." They just aren't there.

In terms of new BDCs, you're absolutely right. A lot of these guys, when they form a new BDC, they've been operating a BDC for the last 10 years in some other capacity. We meet with everybody, and we try to meet with the team and understand their ability to underwrite. We want to see the credit memos. We want to understand, are you re-underwriting or do you have your own model? Or are you using the private equity firm's model? And do you adjust EBITDA from the private equity numbers to your numbers? You want to understand what's actually going on.

But I do think from a trading perspective, some of the new BDCs may not trade as well as the ones that have gone through cycles before, just because the market's unsure how they're going to do. And I think Owl Rock struggled for a while, they were trading very low price to book, and they've come back up to 90% of book. But a lot of that I bet is just people want to see how they do through the cycle. But then you have Ares, they're trading like a champ at a premium to book, and the market's giving them credit for all the history. Ares has generated 10% ROE since IPO, which is a very high ROE, and they've been through a couple of cycles. So that's tried and true, the market's giving them credit that they'll get through this cycle as well.

Jorge Solares: Yeah, and that brings me back to the topic of M&A. For instance, Ares has generated some of its return by doing smarter positions. They've taken advantage of other companies, very large ones, that have got into trouble due to credit. And they've taken them over and they've done at least three sizeable acquisitions that I can think of other BDCs. And the one thing that's super interesting is that over the years, I've been on the sell side, selling BDCs and running auction proxies, and that's really the most telling.

Someday I'd love to have a coffee with Mitch and just tell him it's like unbelievable but this asset manager, I'm thinking of one right now which is sponsored by a PE firm, they have a pretty brutal reputation for being incredibly tough and not likable, and the BDC manager's management team, I'm in shock at how thorough they are. They were the most painful of all the buyers by a long shot, by a mile. My team was getting crushed with smart requests, not just blanket requests for information but smart requests. And ultimately they gave us a price and it was the lowest.

And you know what? They were goddamn right. I sold the company for higher to somebody that did far less work than them, had no idea what they were buying, and they're now suffering some of the consequences. And that's when I look at it and I'm like, oh my god. And I told the CEO, I said, "By far, hey, I hope you don't mind, but you are the biggest pain in the ass of any of the buyers. Your team was so unbearable. But they were professional and they asked the right questions. I didn't feel like it was a waste of my time because they were asking the right questions. And you guys ultimately bid, which I appreciate, and I'm not even insulted by your price. My client was super insulted and I know they said that you had wasted their time, but I don't think so."

And I bet you that if I go back, that guy was right. Because the losses were significant enough that that was the only price that ever made economic sense. But there was somebody else who was more incented to get scale, to grow, to be able to issue stock for this company. And they rationalized their behavior and their decision with facts that they configured in the right way to communicate a message to their investors as to why this acquisition made sense.

But like Mitch said, I always question peoples motivation. What's their incentive to tell me that? What do they have to gain or lose? And I think you have to be that way with a lot of these managers. And getting back to the original question of does size matter and all that? To me the only thing that matters is how invested is the management team to that vehicle? Because I know very large managers that run very small BDCs, and that vehicle unfortunately suffers because they view it as a nuisance. They're a public company, "God dammit, it has our name on it and it trades like crap. Why do we have that crap down there?"

And of course a management team, they don't want to talk about it because that's an embarrassment. They'll even change the name of it to something else. They'll do that. And I swear to god, this has happened. Yet there are other managers, like this one, where this is a very insignificant piece, but to their management team it's their only job. They have been hired to run that vehicle, and their future success is dependent on that vehicle's success. And I would much rather have that.

And then there are all these examples, like TSLX where management team, they have many jobs, with maybe the exception of Ian, the CFO, but they have many jobs. But they really do care and are highly committed. And that's really at the end of the day what's key to me, is how important is this to the management team? Either economically or just reputationally, or how hard do they want to work on behalf of the shareholders?

Mitchel Penn: When you guys are talking with management teams, are they willing to give you numbers? When they talk, are they willing to back it up with numbers? If they are, that's something that you can benchmark against, that you can test. If they're not willing to give you numbers, then maybe they're just talking to talk, and you just have to watch stuff like that.

Dan Silver: So it definitely sounds like the answer is it's complicated. These days it's complicated. And here's where I'd like to get some forecasts and maybe best guesses. On the one hand price matters, but on the other hand who knows how 2023 is going to play out? So we can all see what's happened recently with NIM. The question is, as rates are higher what happens with origination volumes, what happens with credit?

How do you think the public markets, the traded prices of BDCs is going to behave if we're kind of muddling along? Or maybe that's one case, maybe you'd like to characterize other ones.

John Cole Scott: Yeah, I'll start a little bit. I would say that while retail investors are predominantly the shareholder base of BDCs like closed-end funds, but with the plethora of dividend increases, those people really are going to be noticing the special dividends which are common for about a third of the universe currently, and the dividend increases with coverage. And so while Mitch is right, ROE is very, very important, but it's nice to have dividend coverage on the adjusted core NI or NII, depends on what you're looking at.

So with the ability to say dividends have grown faster than inflation, and how many products can say that in the capital markets? I think it's going to be very positive to it. I think that while the recession's eventually going to happen, I worry less about the NAVs and the portfolios based on the experience through Covid for management teams and how they dealt with that violent action. I don't expect a recession like that for a while.

We'll go back to [inaudible]. We're trading 17% below I think the five-year average premium or discount for our index. Our index is basically, if you're a debt-focused BDC, you trade at a million dollars in liquidity, you're equal weight every 90 days. So it's trying to litmus test the market. I think we'll see higher prices.

Mitchel Penn: So for me I worry. We've come up a lot in the last couple of weeks, and we were sort of huddling around 80% of book for the group. We'd even touched a little lower and now we're right around 90% of book. And a lot of that's because they've increased the dividend, people are now comfortable that the yield's going to increase. Like we saw a nice jump this quarter, we're probably going to see another jump in Q4 and maybe Q1. But the thing I worry about is credit losses, and when those start to emerge, does the market just dump the stocks? Because they're not going to understand, they're not going to have a lot of clarity around how bad is this cycle going to be?

What we've been telling folks is average in. So buy 25% at today, if it goes down to 70-80% of book, buy another 25%. If it goes up, maybe wait on buying. But buy the dips is what we're trying to tell folks, and do it over the next three to six months because the Fed, everybody thinks the Fed is getting closer to the end of this cycle but we don't know, and we also don't know how losses are going to emerge.

One BDC who I really respect on credit, they thought you'd have 2-4% defaults a year for two years and it would be a little longer cycle, and it wouldn't be deep but it would be just long. Well, 2-4% is fine for BDCs, they can deal with that. Because remember, they're getting 2% extra income these years, and so they can cover that extra loss with just the extra income that they got. Because 2-4% default at 50%, that's 1-2% losses. It's right in line with the 2% that they're probably going to get in additional income from the rise in rates.

But I still worry that you get these kneejerk reactions by the market. And I think if you're patient there's enough volatility, BDCs are very inefficient. And you're an institution, so it's harder to do this, but I talk to a lot of small accounts in retail and RFAs at Oppenheimer, and we try to just say, "Look, you have the ability to be patient and buy the dips, and do it over six months," and that tends to work.

The other thing I will mention is if you're risk averse, buy the BDC bonds, they're at 9%, 8-9% and they're four-year pieces of paper. You can buy that bond, and in four years when it matures go buy the equity because we'll be through the cycle in four years. And so if you have that kind of flexibility, just buy the bonds, you can sleep at night, you don't have to worry about credit losses, you don't have to worry about anything. Because again, the leverage is so low. And think about buying a bond at 8%, you know what the average ROE for a BDC is since IPO? It's 7.2%. So you're getting a bond that yields more than the average ROE that the group generates. And you're getting it for four years and then you go back in after the cycle and you don't have to worry so much about the credit losses.

Jorge Solares: I agree with most of that. With the exception that if you buy say an Ares today, even where they're trading today, chances are that when we get out of this they'll be trading higher. But chances also are that we'll have acquired something. Chances are they'll have issued stock at above NAV, which is accretive to everybody. Because if you issue stock at a multiple of book value, your book value's going to grow just from financial engineering.

And so I would say that I don't like bonds but I'm also an investment banker, maybe I have a higher risk tolerance, especially with other people's money. I don't know but I would say the bonds seem so boring to me, I would much rather buy an Ares, a TSLX, a Hercules, those three, and just know that those guys will likely be winners tomorrow as well like in the past. I'll put all my eggs in that basket and know that they'll be able to have better access to the capital markets than anyone else in a turbulent time, they'll have better strategic opportunities, they'll have better investment opportunities because they have a larger funnel. If anyone's looking for VC financing they're going to call Hercules for sure, Triple Point as well, but that's a great manager too and with a phenomenal management team. But Hercules has a longer track record.

So that's what I would do, I would be invested. And I agree with the strategy of buying some now, some later, et cetera, but I think it's a really good entry point I think for anyone looking at the BDC market. Now this is the kind of environment where you can make outsized returns, because it's not just the ROE but it's the NAV appreciation and the top managers typically trade at a multiple to NAV. So if you buy it now and they're going to have NAV valuation over time, appreciation as well, then you're getting an outsized return in my humble opinion.

Mitchel Penn: Yeah, look, if you are comfortable with the credit environment and you think credit losses are going to be relatively low this cycle, by all means, buy the equity. But there's always a group out there that is very conservative and so we just say buy the debt. And what we find, this has been my experience, is they buy the debt, within a year they're buying the equity, they get more comfortable. So it's a learning process.

Because there are people out there that'll just say, "I don't understand BDCs, I don't want to buy 'em." And you're pulling your hair out because you're going, "No, no, you do need to own this space. It does fit in your portfolio, provides really good benefits when rates rise, and it's a good diversifier." So you just have to get them in some way and we use debt as a starter for the particular difficult clients. And I agree with you, TSLX, Ares, Hercules, all great companies.

I would argue one thing, as you issue above book, you raise the NAV. What tends to happen over time is your ROEs drop a little bit because your book value's increasing. But we agree, those are great names.

John Cole Scott: And it's worth noting, we don't own the debt of BDCs, and partially because we're comfortable with the volatility of the equity, but it's a lot, very thinly traded. I have a lot of individual data clients that basically sit trying to catch those bonds if they fall a little bit out of favor, and the liquidity there is far less than being able to trade. Even the couple hundred million dollar market cap BDCs, you can buy a lot of volume on a day.

And we also love to buy after the secondaries, so if you're trying to have a reason to get into the fund, it's great to go in after that secondary if you already like the name. And then we also, when the RSI is looking cheap or the VIX is going crazy, people tend to sell their listed BDCs before the muni bonds.

Jorge Solares: The last thing I'll say is that I think there's also a real opportunity out there with the regulatory performance, it's been on the horizon for years and years and years. And if that ever happens, I think that you'll see a normalization of BDC investors, and that investor universe will look a lot more like REITs. Which are dominated by institutional investors, they still have a ton of retail buying it, but it's not the current situation where institutional investors have so many reasons why not to own a BDC, no matter how good they are. They have AFFE with acquired fund fees and expenses that they have to add to their load, they somehow invests in an externally managed vehicle where the SEC says, "Oh my god, no, you're effectively handing off the investment management to someone else and you have to include their expenses." There's so many disincentives.

And then because of that they've been taken out of all the indices, so the managers now have that dilemma, do I want to own something that's not in the index? It can't hurt me, it can't help me. There's so many reasons why. And also considering liquidity, as John talked about, that's huge.

But there’s so many reasons why if you’re an institutional investor it’s not worth the headache to own a BDC.

I think the minute that goes away and you start seeing institutions come back, particularly in an environment like this where there’s wreckage, where there’s dislocation in valuation, et cetera, these are great entry points. So if those two worlds collide where this sector is beat up enough because of what’s happened on the credit side, and you know which ones are likely to be the winners and the valuations attractive, and all this reform finally happens. Those two things will contribute dramatically I think to an increase in the overall valuation of the sector.

Mitchel Penn: So if you do the numbers, what’s really interesting, it backs what you say up. If the BDCs go into a Russell Index, we estimate that the indexes would have to buy 10% of the outstanding of all the BDC equity. Well, as you point out, doesn’t trade really well, 10% would be a huge--

John Cole Scott: It trades better than regular closed-end funds, but not like Apple.

Mitchel Penn: Right, right, but the lift that you would get is tremendous. But the real benefit is management would be held accountable and you’d have probably better returns. Sell-side analysts, we can question management, but if somebody who owns the stock calls, I was on the buy side, and calls and yells at the management team and says, “What are you doing!? Why aren’t you buying back stock when your stock’s at 70% of book?” They have a much harder time saying no. And if you get a lot of institutions, who they’re pretty smart, they’re all probably saying the same things. You’re getting to get better accountability and the industry’s just going to be better off. You’re going to have much better liquidity. Yeah, the BDCs will be bigger but that should ultimately be good. It will be like the REIT, I agree.

Jorge Solares: Yeah, and going along the lines of what Mitch is focused on, which is ROE, their cost of equity’s going to go down. That’s going to have a huge impact, ripple effect throughout the sector. And Dan asked me a question that’s related to what Mitch just finished talking about. “Hey, who’s the smart money in the sector?” I’m like, “Honestly, there’s smart people, but there’s no one that would get on a call.” There’s no equivalent of Bill Miller, to pick on him, there’s none. There’s no person that can get on an earnings call and ask management a tough question where they're going to shake in their boots. There’s no T. Rowe, there’s no Wellington, there’s no Fidelity that can really impact one way or another.

Mitchel Penn: This is really timely. So the best example of somebody actually doing this is Lee Cooperman on FCRD, right? Lee got on the calls and just told the company, “Hey, this doesn’t make sense. I think you should sell it. You’re not generating high enough returns. You’re not able to sort of fix this thing.” And guess what? They sold it, or they’re in the process of merging. But he’s the only guy I’ve ever seen do that.

Jorge Solares: But he talks. I’m an investment banker and he calls all the time. He drives me sometimes nuts. But it’s all talk. At the end of the day, the only guy who’s really done anything about this to clean up the sector is Josh. Josh Easterly is the only guy who has walked the talk or however you say it. He’s gone after management teams. And he’s done it, he says, and I believe him, for the benefit of the overall industry because he wants to clean up some of the mess that he saw at the time. And whether he picked on the right people or not, that's another debate. But he's the only one that's really backed it up.

Because Lee is relying on other people to do the grunt work. The, "Okay, let's put together a presentation so we can send it to the independent directors so that we can really influence their behavior going forward." Because that's the one benefit of all of these companies, they have independent directors, and that's why I always believe on the marks. Because the independent directors have to sign off on those marks every quarter.

And they're scared to death, they don't want to be in cahoots with management by signing off on lazy work that management provided them, they want a third party. And you know what? Increasingly those third parties get sued. Their bank's like mine, right? We don't do that work but Houlihan Lokey doesn't want to get sued. S&P, they don't want to get sued. And the directors are going to hold them accountable and they're going to look to them and say, "Why is it you told me these marks were reasonable?"

John Cole Scott: I think we're going to try to do some questions now.

Dan Silver: I was about to say, I think it's that point in the session. So why don't we open up to the audience? Are there any questions for our panelists? Yes, sir?

Audience: Is there any sort of standard for how managements get compensated? Is it a straight maximum fee based on management? Is there any sort of carried interest where in an equity investment that's, right now, do they get a slice of the capital gain?

Mitchel Penn: So the question is, is there any standardized management contract, right? Or compensation system. And for externally managed BDCs, they typically get a base management fee which can be anywhere from 1% to 2%, and an incentive fee. Which they've got a hurdle rate of like 6-8%, and they get an incentive fee above that up to like 2% higher. So if it's six, you go from six to eight, and then anything above eight gets shared 80/20. They're all different and some have catchups.

So for example, some reset every year. So that if you have big losses in one year, yeah, they might not get an incentive fee, but the next year the clock starts new. Whereas some guys, they have a lookback, and the lookback goes back to IPO. And so they have to get you as a shareholder, whether it's 6% or 8%, so that you get a reasonable rate of return over the life of the BDC. And so, yes, you need to read, and it's disclosed in the financial statements exactly what the formula is. And you need to look at that because it does make a difference.

Jorge Solares: But it's not clear, I would say. When I read those sometimes I'm like, oh my gosh, what? Because of the way it's written, it's super confusing. And it's the SEC writing it, it's not really the manager trying to hide it. So the easiest thing is to pick up the phone and call Mitch and say, "Hey! What's the structure for this one?"

Mitchel Penn: So you're absolutely right. We end up calling every company and having them send us a spreadsheet that shows us exactly how it's calculated, because it never adds up. Every quarter we have an issue with at least one BDC where the incentive fee didn't work. And this quarter we had that issue and we didn't understand what was going on. They have a cap, they have yearly caps and it's strange.

Jorge Solares: And the way I look at it is, if they're really good, it really doesn't matter whether it's egregious or not. Because some of these management teams, they realize that they have to be attractive to institutional investors long term. And so they will modify their own management fee structure if they think it's egregious. Why? Because it's not in their interest. Because no institutional investors going to buy off on some 100% catchup provision, that's ridiculous.

The catchup provisions to me, I fight with some of my clients all the time over this, they're not investor-friendly. They're just not. I've shown them, there is no point that you'll ever convince me that a shareholder would be better off by giving you a catchup provision, it's not shareholder-friendly.

Mitchel Penn: And that's why we look at ROE, because it's net of whatever crazy formula they have. We just look at ROE, and if you generate a good ROE, we don't care what they pay.

Jorge Solares: It doesn't matter whether they have a catchup or not catchup, it doesn't matter.

Mitchel Penn: Yeah, that's right.

John Cole Scott: And I'll just share one thing we've done in our data business is we have really granular expense ratio data for all funds, and really granular leverage data. And we do, on the profile pages for listed BDCs, have that non-leverage expense ratio, that gross non-leverage type of data. So it's a way to look at the total math of their quarterly financial statements and try to normalize it. No data point is ever perfect. If you think data's perfect you're probably going to make a lot of mistakes and we'll be happy to catch your trades. But it does just try to give that actual knowledge so it can be normalized and understood.

But you're right, at a certain point you don't sift for closed-end funds or BDCs on expense ratio and shop in the lower quartile. You may get there, but not from that analysis.

Mitchel Penn: The big differentiator for all BDCs is going to be credit. That's going to drive your decision ultimately whether you want to own BDC A or BDC B. It's their ability to underwrite credit.

Jorge Solares: No pun intended, BDC A.

Dan Silver: All right, well, with that I think we are out of time. With that, I'd like to thank the panelists, much appreciated.

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