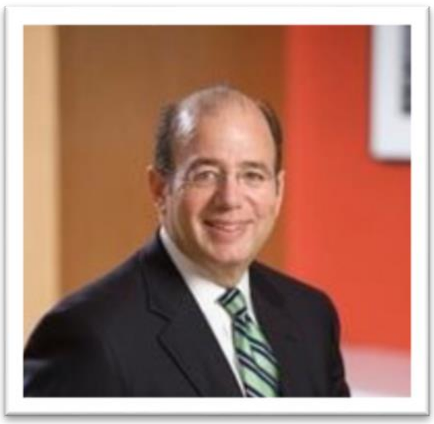
Bonus NAVigator: Oppenheimer's Penn Is Watching How Credit Losses Weigh On BDCs

Friday, June 13, 2025



Chuck Jaffe, in this episode of The NAVigator podcast interviews Mitchel Penn, Managing Director at Oppenheimer & Co., interviewed at the Active Investment Company Alliance BDC Forum in New York on Wednesday. Mitchel says that credit losses for business-development companies during the first quarter of 2025 were more than double the level they have been at for the last few years. Penn says some of that increase could be attributed to the market's reaction to government policies, but that it also could be that interest rates have stayed higher for so long now that they are starting to create credit-quality issues. He said BDCs can still deliver returns in the range of 9% moving forward, though he warned that an increasing number of business-development companies may struggle to earn their dividends, making it particularly important for investors to check under the hood to make sure the yield is real and not goosed by return of capital.

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

CHUCK JAFFE: Yes, welcome to a special edition, a bonus edition of The NAVigator. We're recording this week from the BDC Forum held on Wednesday, June 11th in New York City, organized of course by the Active Investment Company Alliance. We're bringing you three interviews from the conference site, so extra content, and with everything that's been going on with BDCs, there's a lot to talk about. Here to discuss it now, Mitchel Penn, managing director at Oppenheimer & Co., he oversees their BDC investments, and if you want to learn more about the firm and what he does go to Oppenheimer.com. Mitchel Penn, it's great to have you back on The NAVigator, thanks so much for joining me here in person.

MITCHEL PENN: Great to see you. Thanks, Chuck.

CHUCK JAFFE: These are pretty heady times I think for BDCs, at least in terms of what we're seeing with private market, how well they performed, all those sorts of things. As an investor, how happy can you be? Or how much do you look at conditions and go, "BDCs have done well in spite of the headlines, instead of because of them"?

MITCHEL PENN: Yeah, so it's interesting, so for the last couple of years, Chuck, we've seen credit losses around 100 basis points a year for BDCs, and that's what you would expect over the long term, is about 100 basis points a year. However, in Q1 of this year, it went over 200 basis points for the first quarter, and so a lot of that could be just spread widening from all the government policies that have been coming out and causing a lot of uncertainty in the markets, tariffs and what the impact tariffs might have on inflation and on economic growth. And so we're watching that, and I think a lot of investors are looking to see what happens over the next couple of quarters with credit.

CHUCK JAFFE: It's been interesting because as interest rates had gone up, we had expected that we'd see more of a wave of defaults, and that never really materialized. So as you're looking at this current situation, is your fear directly that this is caused by the tariff uncertainty more than anything else? Or is this finally higher interest rates and they're coming home to roost?

MITCHEL PENN: So it's like anything else in life, it's complicated, right? And so it's probably a little bit of each, but some of it is just the time that rates have stayed high, and the other is that you're not seeing a lot of M&A. So most of the time a BDC makes a loan, it gets prepaid between years two and four, but because prepayments are slow, the M&A market is slow; there's not a lot of transactions going on because of the uncertainty, the BDC debt, that debt's staying outstanding for longer periods of time, and as it does that, you have more chances to have issues, and so I think you're seeing some of that. But I think it's, like I said, complicated, it's a lot of different factors.

CHUCK JAFFE: Obviously there are very distinctive characteristics and qualities that you like in BDCs, but it's also designed to get a return that's within your expected range. For the investor who's out there, who's looking at BDCs and weighing them and doesn't have that kind of background, how would you help them place BDCs in their portfolio, the role you want BDCs to play, and the kind of returns you think the space should generate?

MITCHEL PENN: Yeah, so I think the way investors should think about a BDC is income, so don't buy it because you think the stock price is going to go up, assume the stock price is always going to be right around book value, give or take, and that you're going to earn the dividend, and that's around nine or 10%, sometimes it got as high as 11 or 12% as rates were higher. If rates come down, it'll probably settle in around 9%. It's a good, steady income. What you have to do though is understand, make sure the BDC's earning that dividend, because if a BDC doesn't earn the dividend, they're returning capital to the shareholder, so that's the key, and there are plenty of BDCs that earn their dividends, so just make sure you do the analysis.

CHUCK JAFFE: You talk about BDCs that are and are not earning their keep, it wouldn't have been that long ago that you could have had an event like this one, this is not a big investment conference by any standard, but in the last two decades if you had said, "I'm going to count up the BDCs out there," you would have needed both hands but not your toes, nothing beyond that, and now we've got more new business-development companies in formation than I have hands to count. How much of the growth has been good? How often do you look at a new BDC and say, "I'm excited by this"?

MITCHEL PENN: Yeah, so we don't get emotional about anybody, but we do look at their earnings, and as long as they're earning a good return on capital, then we're fine with that BDC. It's the BDCs that underearn, that earn 4% ROEs or 5% ROEs, those are ones where if they're paying out a 12% dividend, the difference between 12% and let's say 4% is eight, that 8% is return of capital, and that's going out of the business. It doesn't make any sense to us that these BDCs that underearn just keep these dividends very, very high. We think ultimately those dividends will come down. So as an investor, you really want to pick the BDCs that earn 7, 8, 9%, they can cover their dividend.

CHUCK JAFFE: Let's talk a little bit about market conditions. I mean, you were just talking about what's happening with interest rates. What's your outlook on what happens with rates?

MITCHEL PENN: This is a great question, because there's so much uncertainty right now. We don't know the answer, and so what we tell folks is if you're going to buy BDCs, buy a basket so you have diversification, because we don't know if the tariffs are going to impact certain BDCs or not, we don't know if there are other changes, remember government spending has come way down, they're canceling certain contracts, you don't know if those contracts or those companies were part of the BDC investment portfolio, and so I would just say diversification is key, and that'll protect the average investor.

CHUCK JAFFE: When people hear tariffs, they don't think that a business-development company is going to wind up being impacted, but obviously they are. I mean, that's what you're saying here, is that there's a lot of untold stuff that you just can't figure out how it's going to play.

MITCHEL PENN: So from a direct standpoint, it's only going to be five to 10% of their loans affected, but indirectly, if we go into a recession or if the economy slows, that's where it has impact on everyone. And remember, they're lenders, those companies need to perform in order for the lenders to get paid.

CHUCK JAFFE: How worried are you about recession? It seems like most recession worries have faded away, at least for the rest of this year into 2026, are you worried that one's coming?

MITCHEL PENN: It's always in the back of our minds, and so we have scenarios that we run to look at how BDCs are priced relative to recession risk, and right now they're not pricing in a recession.

CHUCK JAFFE: Is there a flip side to this, that while tariffs are worrisome, the policies of the government which are trying to nearshore things where there's at least hope that we're going to create a big capital expenditure cycle? A capital expenditure cycle needs money, needs credit, so wouldn't that therefore be, if we survive the tariffs, we have a boom time coming?

MITCHEL PENN: Yeah, if the economy's growing, then we don't have any worries because companies should flourish and there'll be new investment, but if the economy slows and goes negative, that's what we worry about. Look, the market, we look at the high-yield index, and when the high-yield index, the option-adjusted spread gets above 600 basis points, signals a recession. That spread's at 300, it's half, so it's not signaling a recession at all, we just always look at these things just to make sure investors know what the risks are under any scenario.

CHUCK JAFFE: And out of curiosity, how quickly does that measure move or change? If we're at halfway, and it's not really halfway because it's not a path that you're taking, how quickly does that change? How much advance notice do you get if it looks like it's falling there?

MITCHEL PENN: It depends. In Covid you didn't have a lot of advance notice, right? And it was literally in a month it really you had a recession, but in normal situations, you'd have a little bit of knowledge, but the stocks are going to reflect that stuff pretty quickly. We keep an eye on it, like I said, normally there are not many changes in government policy, they tend to be gradual. This situation is more fluid, and so it's just something that we're trying to let investors know you need to think about.

CHUCK JAFFE: Well, thank you for taking the time out to make sure we're thinking about it properly. Mitchel Penn, I appreciate you joining me on The NAVigator.

MITCHEL PENN: Thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance, which sponsored the BDC Forum, and Money Life with Chuck Jaffe, which is my show. I'm Chuck Jaffe, check us out at MoneyLifeShow.com or wherever you find your favorite podcasts. If you're looking for more information on business-development companies, but also closed-end funds and interval funds, go to AICAlliance.org, it's the website for the Active Investment Company Alliance. Thanks to my guest Mitchel Penn, he's managing director at Oppenheimer & Co., which is online at Oppenheimer.com. We'll be back to our regularly scheduled NAVigators, which means Friday, but if you want to make sure you don't miss a single episode, follow along on your favorite podcast app. And if you like us, leave us a positive review, tell your friends about us, because those things really do help. Until next time, happy investing, everybody.

Recorded on June 13th, 2025

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