Bonus NAVigator: Gladstone's Bob Marcotte At The AICA BDC Forum

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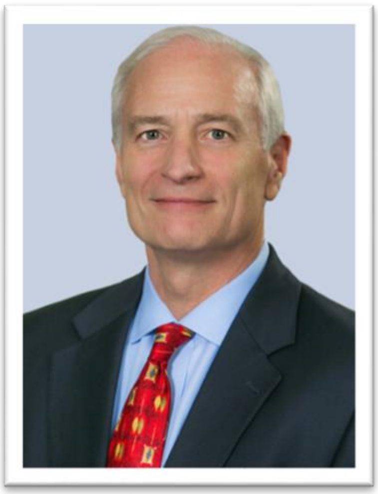

Chuck Jaffe, in this episode of The NAVigator podcast interviews Bob Marcotte, President at Gladstone Capital Corp. Bob says that government policies which encourage business investment and capital expenditures are creating outstanding conditions for the private credit market. In an interview at the Active Investment Company Alliance BDC Forum in New York City, Marcotte said that Gladstone is "very bullish" on the likely capital-expenditure cycle being spurred by tariff and near-shoring policies, but the veteran money manager also noted that BDCs have never been more competitive with the public markets thanks to rapid expansion in recent years, moving the industry to a point where "there's so much money in the private market today that it's almost as liquid as it would be if it were in the broadly syndicated market."

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

CHUCK JAFFE: Welcome to a special edition of The NAVigator, because this week on June the 11th, the Active Investment Company Alliance held its first BDC Forum in New York City, and I went down to moderate a panel and talk with some of the experts there, and we're going to start today with this interview. Bob Marcotte, he's president at Gladstone Capital, if you want to learn more about him and the firm, it's GladstoneCapital.com. Bob Marcotte, thanks so much for joining me.

BOB MARCOTTE: Certainly. Nice to meet you, Chuck.

CHUCK JAFFE: We are living in times where I can't talk to any mainstream money manager without them saying, "Hey, private credit space looks good to me." It has brought tons and tons of interest, but with interest comes scrutiny. You've been doing this, I'm not calling you old, you've been doing this for a while, Gladstone is one of the bigger, older players, more established players, what has all of the flood of interest done to change the business?

BOB MARCOTTE: Well, I think it's given a little bit of credibility. The business started back in the 2000 timeframe, and it was a small backwater of investing. In fact, Gladstone originally went public in 2001, so it's been around almost 25 years. I think the interest and the scale has given a measure of credibility. It's always been a business that invests in business, that engages with business, and passes through the returns associated with those investments to the investors, but it never was adopted, acclimated, it was never institutionalized. It has now been institutionalized with the large money manager platforms that have raised capital. So I cheer the introduction of all the capital, and it's made a lot more sophistication to the market, but at the end of the day it still boils down to making good credit decisions and managing those businesses appropriately to drive the return for the investors. That's the core of what it is, and I frankly don't think that's really changed.

CHUCK JAFFE: That's the core of what it is, and it hasn't changed, but what has changed is that when you get more competitors in a tight space, you get people who maybe are willing to settle for a deal that's not of the credit quality that you might have wanted or that the industry might have done it. How much do you worry that at some point with the introduction of all this competition and all this interest, we wind up somehow with the space having a black eye?

BOB MARCOTTE: I think it's a fair question. Most of the money that's coming into the market comes in at the top of the funnel, it's the largest eight or nine or 10 asset managers that have overwhelmingly grown their AUM and grown their business. What it has done is really two things. One, it used to be that the BDCs operated in the private markets and the banks operated in the public markets, and there was a premium to operating in the private markets. The private markets have gotten so big and attracted so much capital that it has compressed the premium that a private investment typically would have, and you can make an argument that there's so much money in the private market today that it's almost as liquid as it would be in the broadly syndicated market, so it has compressed the yields in the marketplace. The second thing that I would say is, because there are so many and the transactions are so large, there is a tremendous overlap between a lot of those managers, you'll see them participating in their other deals. So at the middle market and up, and middle market, maybe $50 million of EBITDA on up of investments, there's a tremendous overlap, they're no longer uncorrelated, they're very correlated. They're participating in each other's deals, they're playing in the markets, they're underwriting in a very similar fashion, so the differentiation is diminishing, and so the ability to drive alpha variances in positive is much less available because of the sheer scale of the market. All of that said, the way we operate, we focus on the lower middle market, we generally engage with companies that are less than $10 million of EBITDA, they are typically owner-operator, family-run, they're transitioning from that ownership structure to a small scale private equity sponsor who is looking to buy at a reasonable price, professionalize, and scale the business to drive their returns. We engage at that level, and that's a place where it's much harder to originate, the investments are much more time consuming, and our focus in an area where it's very difficult for the large funds to put out billions of dollars in $10 and $15 and $20 million increments. So they can't come down because of their sheer scale and their fee structures, and from us it's a place where we're willing to commit the time, and we're able to drive better returns and hopefully better returns for our investors.

CHUCK JAFFE: That process obviously has worked for Gladstone for almost a quarter century, but there was an expectation that when we left the zero interest rate environment and we got to higher interest rates, we would see more credit problems, and we really haven't seen more defaults, we haven't seen that sort of thing, at least not yet. If we don't see rate cuts soon, is that coming? Is that still there? Or is that this business has gotten good enough that we're not getting out to where things that are risky or more risky are crashing?

BOB MARCOTTE: It's a complicated question. I would say low interest rates enable people to borrow more than they probably should have, so at the upper end of the market, whether it was five or six or seven or eight times leverage, it's very hard to outgrow that leverage when the costs remain high, and they obviously increased from the lower rates in that timeframe you're discussing. In the lower middle market, because companies don't trade in double digit multiples, they trade at six, seven, eight times, typically leverage is only two to three times. Our average portfolio, X a few special circumstances, is only leveraged about 2.5X, so the ability to absorb what might be higher rates than when they were originally underwritten, or higher rates in general, is much more flexibility, and so we really don't expect a huge problem. It's more likely it's an idiosyncratic problem, it's a large customer of a small business that went another direction or insourced. It's more likely a management team that lost their way and was unable to continue to drive the growth and performance. It was a business that needed to reinvest in the company to drive their costs down and be more competitive by digital tools or automated technologies. And so as long as we focus on the performance and continue investing in the business at the low leverage where we are, we don't see those issues really becoming systemic, and where we can, we engage at a level with the board representation and we will work with the company to address those idiosyncratic problems.

CHUCK JAFFE: While you are talking with managements, these are very interesting times to be running a middle market business that might be looking for capital, because, well, we've got all the stuff that's going on with tariffs and we're trying to near-shore, and all of that has led plenty of people to believe that the next big boom is going to be in CapEx, it's going to be in capital expenditures, and if people are going to make capital expenditures, they're going to be borrowing money. So as you look at this, are we coming to a spot where it's not just there's been this much interest, but that we are about to have a perfect storm of goodness for people in your business?

BOB MARCOTTE: We are very bullish on companies investing in the capital for their business; automation, running lights out, improved quality, improved precision, we've in fact see when companies will invest in that equipment, the customers will take notice. Those aerospace customers see you put in an automated machine, they know what that means, you're going to be competitive, you're going to be a good supplier, you're not going to have labor issues, they're going to see the quality and they're going to see the efficiencies, they will bring business to you. So there is some truth to investing in companies that have the precision and capabilities and the reputation of serving their end clients, it's really a question of what segment they're in, what the growth pattern looks like. Most of our investments, we focused on businesses where the forward visibility of revenues is very strong. If you've been supplying aircraft parts for a class of plane for the last five years, pretty good chance that FAA-approved part is going to be there for the next five, so that's the level of visibility, and so investing in a machine that can improve or expand or add value or reduce the cost of that part is a very easy thing to invest. I would expect that the stronger manufacturers will be investing in that sector because their customers want it.

CHUCK JAFFE: For you at this point, what are the storm clouds on that bullish outlook? Is it the tariff situation, is it higher interest rates for longer, is it sticky inflation, is it a recession? What scares you?

BOB MARCOTTE: I'm not terrified. Most of the BDC investments are smaller domestic companies, and while some may be affected by tariffs, many will not. With time, the supply chains will realign, the implications of the tariff will be muted. What concerns me most is will those changes and disruptions and dislocations cause the end markets for some of these industries, or even the economy in general, to slow to a point of a recession? Then everything pulls back, lead flow, order books, pricing dynamics, all change. So my bigger concern is that some of these will cause a temporary slowdown in the markets, which will be more challenging. If you're a small business, as we all know, a lot of the profitability that drops to the bottom line is on the incremental sales, and so if you lose 10% of sales, you probably lose 20% of your cashflow. So anything that causes pullback in the broader market, despite the strength and capabilities and flexibilities of our companies, is going to defer, and it's a question of are they prepared and do they see it coming and do they have the right leverage structure to work their way through it?

CHUCK JAFFE: Really interesting discussion. Bob, I very much appreciate you taking time out to join me, thanks so much for being on The NAVigator.

BOB MARCOTTE: My pleasure.

CHUCK JAFFE: That's Bob Marcotte, he's the president of Gladstone Capital, GladstoneCapital.com if you are looking for more information.

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TheNAVigator@AICalliance.org

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