STOCK STRATEGIES

Investing in BDCs: Private Equity for Public Shareholders

Business development companies offer the opportunity to invest in some attractive areas; however, there are significant risks.

BY JOHN DEYSHER, CFA

Private equity. You may be hearing the term a lot these days. While billion-dollar deals make the headlines, firms of all sizes (private and public) are being acquired by private equity firms. Although higher interest rates may slow the number of transactions going forward, private equity firms still have billions in capital to put to work on deals.

One way for individual investors to participate is through business development companies (BDCs). They allow public shareholders access to portfolios that resemble private equity funds.

How BDCs Started

Business development companies were authorized by U.S. Congress in 1980 to help fuel job growth and provide capital to small and medium-sized private businesses that lacked access to traditional capital sources, such as banks and public markets. They may also be firms suffering from financial troubles.

While BDCs have been part of the regulatory landscape for decades, their profile has risen in recent years because of the substantial returns generated by private equity firms. Such firms include Apollo Global Management Inc. (APO), Ares Management Corp. (ARES), Blackstone Inc. (BX), Carlyle Group Inc. (CG), KKR & Co. Inc. (KKR) and others. Some have formed their own BDCs.

Traditionally, BDCs provided high interest rate, short-term loans (from three to five years) to small and mid-market companies that lacked access to or were maxed out on traditional bank credit. Such loans could be used to provide liquidity, help fund growth, make acquisitions or facilitate ownership changes. Loans might take the form of a credit line or secured, unsecured or convertible

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debt depending on the borrower's financial strength. BDCs might also extend capital via straight or convertible preferred stock.

The loans often came with equity kickers like warrants, rights or options, and sometimes the loan itself was convertible to equity. If the firm grew and prospered, the BDC got back its principal plus interest and might end up with a small piece of equity. If the firm ran into trouble and was reorganized, the BDC and other creditors would wrestle over who owned what percentage of the new enterprise. In a liquidation, they would share in the net proceeds based on claim seniority.

A typical BDC transaction process goes something like this: Sourcing → Evaluation → Execution → Monitoring → Exit. Deals usually come from a variety of sources, including private equity firms, investment bankers, commercial bankers, business brokers, accounting/law firms and others. Once a potential target is located, extensive due diligence is performed—including qualitative and quantitative analysis to assess strategic, operating and financial capabilities. Execution involves negotiating an acceptable transaction price and determining how the transaction is to be financed: debt versus equity and who provides the capital for each. Equity may be provided by the BDC, the insiders or other financial entities like hedge funds. The debt may be provided by the BDC, investment and commercial banks, private equity firms, public high-yield notes or bonds, hedge funds and other lenders. Both equity and debt deals are often syndicated, allowing the parties to coinvest and spread the risk.

Nowadays most BDCs are involved on the debt side of the equation, which is why most boast significant yields. During the monitoring phase, the BDCs must provide managerial assistance to their portfolio companies which may include strategic, operating and financial advice as well as holding board seats. Exit occurs when the position is recapitalized, taken public or sold to a third party. It may also be written down or off.

Typical Structure of BDCs

Most BDCs are organized as closed-end funds (CEFs) to raise a pool of capital on an initial public offering (IPO) and then trade on a stock exchange. The captive asset base is not vulnerable to shareholder redemptions, allowing

the BDC manager to think long term. Secondary offerings may follow, complete with a prospectus and road show. While the net asset value (NAV), or assets minus liabilities, is normally calculated quarterly via a valuation process, BDCs that trade on an exchange are priced daily.

In addition to equity capital, a BDC may raise debt capital from banks or other lenders including the sale of BDC baby bonds to the public that pay interest on a semiannual basis and mature in eight to 10 years.

Like mutual funds, BDCs are regulated by the U.S. Securities and Exchange Commission (SEC) and usually must meet the following guidelines:

- Invest at least 70% of assets in private or public U.S. firms.
- Provide managerial assistance to companies in the portfolio.
- Meet certain asset diversification and debt level tests.
- Not issue new shares at less than NAV (which would dilute existing shareholders) except via a rights offering where existing shareholders buy the new shares.
- Distribute 90% of all investment income and net realized capital gains at least annually to shareholders who are taxed on distributions at their own rates. Distributions are sometimes made quarterly. Shareholders receive a Form 1099-DIV showing the breakdown between net investment income and capital gains. As long as the 90% requirement is met, the BDC itself pays no taxes.

Benefits of BDCs

BDCs offer a number of benefits to investors including:

- **Liquidity.** No need to put up a $5 million minimum or make a 10-year commitment (lockup). Most BDCs trade at less than $30 on an exchange that offers daily liquidity.
- **Attractive dividend yields.** Because BDCs must distribute almost all their net investment income and net capital gains, yields can be attractive, often in the 10% to 12% range.
- **Upside potential.** Almost every BDC has some element of equity in the portfolio to supplement the income portion. These might include common shares, convertible debt or preferred stocks, warrants, rights or options. If the company is sold—either privately or via an IPO—these securities become quite valuable.
- **Economies of scale.** Operating costs of the BDC manager, outside consultants and attorneys and other expenses may be spread across many deals and make transactions more cost effective.
- **Exposure.** BDCs provide access to alternative investments that aren't widely available through other vehicles in the marketplace and may have little correlation to it.
- **Professional management.** Access to skilled managers with the ability to source, evaluate, execute, monitor and exit portfolio companies on a timely basis.
- **Diversification.** Most BDCs are widely diversified, which helps reduce risk.

BDC Risks

There are also risks associated with business development companies that investors should consider:

Conflicts of interest. A BDC may be internally or externally managed. An internally managed BDC employs its own staff of investment, marketing and administrative personnel who are dedicated to finding investments solely for the BDC. An externally managed BDC has no employees but hires an outside adviser to provide the personnel necessary to oversee the BDC. The adviser for an externally managed BDC may also manage institutional accounts, limited partnerships or other vehicles in addition to the BDC. When a choice investment is found and there's not enough to go around, which investment bucket does it go into? Trade allocation procedures help, but the public BDC may still be at a disadvantage. We knew of one BDC where the adviser set up a private equity fund and an institutional account that competed directly with the BDC for deals—all completely legal if fully disclosed.

High fees. Top investment talent commands top compensation and BDCs are no exception. A typical fee structure is 1% to 2% of gross assets under management (AUM) plus 20% to 25% of any profits upon the sale of an investment. Throw in interest on borrowings and other operating expenses and the expense ratio can mushroom to 10% to 12% per year or higher.

Fair valuation. Since virtually none of the securities held in a BDC are publicly traded and they make no disclosures, the BDC's manager or outside adviser determines the fair valuation of holdings on a quarterly basis. Fair value is estimated using a variety of tools including discounted cash flow (DCF) models, multiples that similar publicly traded companies are trading at or the values that have surfaced in recent merger and acquisition (M&A) transactions. It's part art and part science, but every security must be fairly valued in order to arrive at a quarterly NAV. Typically, the BDC board must approve all fair valuations and revisions if necessary. The BDC's outside auditors may approve the assumptions and methodologies of the fair value process but do not audit each

TABLE 1

A Sampling of Public BDCs

Company	Ticker	IPO Date	10/10 Price ($)	Market Cap ($ Mil)	Dividend Yield (%)	Exp Ratio* (%)	Avg Ann'l Return** (%)	Premium/ Discount† (%)	Target
Capital Southwest Corp.	CSWC	Dec-1984	21.90	880	10.8	10.0	22.7	1.34	Diversified
Fidus Investment Corp.	FDUS	Jun-2011	18.40	460	12.4	12.2	16.2	0.96	Diversified
Gladstone Investment Corp.	GAIN	Jun-2005	12.60	430	7.6	10.7	15.4	0.97	Diversified
Hercules Capital Inc.	HTGC	Jul-2005	16.00	2,310	12.0	10.8	10.8	1.45	Technology
Horizon Technology Finance Corp.	HRZN	Nov-2010	12.00	380	11.0	13.8	10.5	1.08	Technology
Main Street Capital Corp.	MAIN	Oct-2007	39.50	3,260	7.1	6.7	14.4	1.43	Diversified
Prospect Capital Corp.	PSEC	Jul-2004	5.90	2,400	12.2	10.6	10.0	0.64	Diversified
Sixth Street Specialty Lending Inc.	TSLX	Mar-2014	20.00	1,750	10.0	11.2	11.1	1.20	Diversified
Averages				**1,484**	**10.4**	**10.8**	**13.9**	**1.00**	

**Ratio of operating expenses including management/incentive fees, interest expense and other operating expense to average assets for last five years.*
***Based on market values for last five years.*
†Market price divided by NAV as of 6/30/2023.
Source: SEC filings, company websites and author. Data as of 10/10/2023.

company in the BDC portfolio. The portfolio companies typically have their own certified public accountant (CPA) to audit the books. Accurate fair values are essential since using overly optimistic assumptions (even unintentionally) can result in an inflated NAV, which has sunk more than one BDC.

Small-company risk. Most BDC targets can't get financing through existing channels because of the risk or costs involved. Small companies often have limited customers, product lines, marketing budgets, distribution channels, management talent and financial resources, making them more vulnerable to economic downturns. The risk of bankruptcy or default is higher, and the entire investment may be lost.

Borrowing risk. Since BDCs must pay out 90% of net investment income and net realized gains and cannot issue new shares except at a premium to NAV or via a rights offering, incurring more debt is often the only way to raise capital to grow the business. Additional leverage magnifies the potential gains or losses on the amount invested. Rising interest rates are a double-edged sword since they increase the interest rates on the credit a BDC extends but also raise the cost of capital on money a BDC borrows. Many BDCs that have debt rolling over in the coming months may be forced to pay higher rates for similar terms, which in turn means they must reduce borrowings or earn more on extended credit. Matching assets and liabilities is critical in the current environment. Losses on portfolio loans may trigger covenant violations on the credit facility and reduce or eliminate the potential for further borrowings.

NAV discount risk. Like all closed-end funds, BDCs are vulnerable to the possibility that, during a market or industry downturn, the market price may fall below the net asset value. An investor may exploit this by purchasing shares of high-quality BDCs at a big discount to NAV and then waiting for the turmoil to subside and the discount to narrow. BDCs may also trade at a discount to NAV if underlying performance has been lackluster, while those trading at a premium are usually performing well.

Bad deal risk. The market for BDC investments is highly competitive and poor underwriting can result in a write-off that can seriously impact a BDC's returns.

How to Evaluate a BDC

Table 1 shows a sampling of public BDCs.

If you are interested in testing the BDC waters, here are some questions to ask when evaluating individual BDCs. Most can be answered by reading the BDC's annual report, SEC annual Form 10-K and proxy statement.

1. Who's the adviser and how much stock do they own?

As with other investments made at the Pinnacle Value Fund, we like advisers who are also owners and have their wallets (or pocketbooks) on the line every day as we do. The higher the ownership, the better. Both internally and externally managed BDCs must file proxies with the SEC that should be read carefully to assess insider ownership levels, whether there are 5% shareholders and how significant related-party transactions are.

2. What are annual returns over at least five to 10 years, including appreciation and distributions?

This return information may be found in the Financial Highlights notes section of the Form 10-K. Typically, annual returns are shown for each of the last five or 10 years. Often there are two types of returns listed, one based on changes in market values and the other based on changes in NAV. Both include the reinvestment of distributions, which is desirable. Table 1 shows market value returns.

3. What's the expense ratio?

As shown in Table 1, most BDCs have expense ratios that are off the chart. We're willing to pay a higher ratio if the manager/adviser has generated consistent, above-average returns over the long term.

4. How is the financial leverage; how much has the BDC borrowed?

Especially in the current environment of higher interest rates, it's critical to know the terms of the underlying debt—what is the interest rate and when does the debt mature? Given the risks involved with target companies, we prefer BDCs that borrow prudently and maintain an unleveraged balance sheet.

5. What's the distribution payout ratio?

To attract and maintain an investor base, some BDCs pay out more than they earn. The difference is a return on capital. Over time, return on capital payouts will erode the NAV, which is not good for shareholders. We prefer BDCs that don't pay out more than they earn, even if the result is a lower yield.

6. Is the BDC managed internally or externally?

As previously discussed, we prefer BDCs that are managed internally by a group of employees dedicated to finding the best possible investments for the BDC's shareholders. Unfortunately, most BDCs today are externally managed by advisers who often manage other investment vehicles in addition to the BDC. Such BDCs have trade allocation procedures but conflicts of interest may still arise.

7. Are you comfortable with the underlying investment?

Most BDCs invest across a variety of industries, but some focus solely on a particular industry such as technology, telecommunications, life sciences or energy. For example, Hercules Capital Inc. (HTGC) and Horizon Technology Finance Corp. (HRZN) focus mostly on technology and life sciences.

8. How concentrated are the investments?

This may take some digging. While all BDCs disclose a Schedule of Investments on a quarterly basis, it is often up to the shareholder to calculate which of the positions are the largest based on the fair values. Heavy positions can become problematic, and we prefer a diversified portfolio.

Conclusion

Clearly, BDCs aren't for everyone. Most offer liquidity, income, upside potential, professional management and the opportunity to invest in some attractive areas. There are significant risks, however, including high fees, financial leverage, conflicts of interest and risky underlying investments, to name a few.

Most BDCs have websites where you can find information including annual reports, types of investments, advisers, leverage employed, expense and payout ratios, distributions and other important data. All file documents with the SEC, which you should read carefully, including Forms 10-K (annual report) and 10-Q (quarterly reports), 14a (proxies) and 8-K (material events).

A list of BDCs may be found at www.quantumonline.com under the Stock Lists drop-down menu. (It is free with registration.) You may also find BDC details at www.bdcinvestor.com, which provides lots of good information on the sector. If you're not comfortable owning individual BDCs, there's an exchange-traded fund (ETF)—VanEck BDC Income ETF (BIZD)—that invests in a basket of larger-cap BDCs. As with individual BDCs, be sure to read the supporting documents carefully.

Take the time to analyze and identify BDCs you want to own based on your risk profile and income requirements. Then when the time is right and the market price is where you think it should be, make your move. While it's gratifying to your ego to invest with the big guys, don't pay up for mediocre performance or greedy managers and be sure to watch the financial leverage. Happy hunting. ■

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