Investing in BDCs: Private Equity for Public Shareholders

By John Deysher

Private equity.

That's a term we're hearing a lot about these days. Billion-dollar deals involving companies going private, once a rarity, are now commonplace. Interest rates are low, corporate profits are high, liquidity is robust and burdensome government regulations (Sarbanes-Oxley) are causing many companies, large and small, to pull the plug and go private.

Want a piece of the action?

There is one way: Business Development Companies (BDCs), which allow public shareholders access to portfolios that resemble private-equity funds.

If you have never heard of BDCs, read on.

How They Started

Business Development Companies were authorized by Congress in 1980 to help provide capital to small- and medium-sized private businesses that lacked access to traditional capital sources, such as banks and public markets.

While BDCs have been part of the regulatory landscape for almost three decades, their profile has risen in recent years because of the eye-popping returns generated by private-equity funds and the recent initial public offerings of major players like Apollo (AINV), Ares (ARCC) and Natural Gas Partners (NGPC). One of the largest private-equity firms, Blackstone, recently filed to go public.

Initially, BDCs provided primarily high interest rate, short-term loans (from three to five years) to private small- and middle-market companies that lacked access to or were maxed out on traditional bank credit. Such loans would be used to help fund growth, make acquisitions, or facilitate a change in ownership.

The loans often came with equity kickers like warrants and rights, and sometimes the loan itself was convertible to equity. If the firm grew and prospered, the BDC got back its principal and interest and might end up with a small piece of equity. If the firm failed and was reorganized, the BDC and bank (if any) would wrestle over who owned the new enterprise. In a liquidation, they would share in the proceeds based on claim seniority.

BDCs would rarely invest large amounts on an equity basis because of the risks inherent in small-company investing. Secured debt backed by solid collateral was the preferred way to go in case the company ran into trouble.

Nowadays, BDCs have the flexibility to make investments across the entire capital structure of a target, including senior (secured) and subordinated (unsecured) debt, common and preferred stock and convertible securities. Indeed, equity investments have become much more common against the backdrop of soaring worldwide stock markets. Purposes have expanded to include leveraged buyouts of private and public firms large and small. Large firms like Sallie Mae (SLM) and First Data (FDC) recently announced plans to go private. The game has clearly changed since the first days of BDCs.

Typical Structure

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

Table 1. Public Business Development Companies

BDC (Exchange: Ticker)	Price ($)	IPO (Date)	Mkt Cap ($ Mil)	Yield (%)	P/E (X)	Expense Ratio* (%)	Prem (+) or Disc (-) to NAV (%)	Target
Allied Capital (N: ALD)	30	1960	4,500	8.7	23	5.6	+60	Diversified
Amer. Capital Strat. (M: ACAS)	46	8/97	7,400	7.9	15	6.1	+60	Diversified
Ameritrans Capital (M: AMTC)	5	4/94	16	0.0	NC	9.5	–10	SBIC Loans
Apollo Investment (M: AINV)	22	4/04	2,200	9.0	14	4.6E	+40	Diversified
Ares Capital (M: ARCC)	18	10/04	1,200	9.3	14	8.8	+20	Diversified
Capital Southwest (M: CSWC)	170	7/61	660	0.0	4	0.5	+20	Venture Cap
Equus Total Return (N: EQS)	9	7/92	80	5.6	5	4.5	–20	Diversified
Gladstone Capital (M: GLAD)	23	8/01	320	7.3	13	9.5	+70	Diversified
Gladstone Invt. (M: GAIN)	14	6/05	240	6.3	22	2.6E	+10	Diversified
Harris & Harris (M: TINY)	12	3/83	260	0.0	NC	8.5	+160	Nanotech
Hercules Tech. (M: HTGC)	14	7/05	330	8.4	16	7.5	+20	Technology
Kohlberg Capital (M: KCAP)	18	12/06	330	6.4	14	2.7	+30	Diversified
MCG Capital (M: MCGC)	18	11/01	1,100	9.0	12	5.5	+60	Diversified
Medallion Finl. (M: TAXI)	12	5/96	220	6.0	21	6.5	+20	SBIC Loans
MVC Capital (N: MVC)	18	4/00	440	2.6	6	5.3	+30	Diversified
NGP Capital Res. (M: NGPC)	16	11/04	290	6.4	15	3.7	+15	Energy
Prospect Energy (M: PSEC)	17	7/04	350	8.8	12	6.5E	+15	Energy
Rand Capital (M: RAND)	4	7/80	20	0.0	3	6.6	+30	Diversified
Technology Invst. (M: TICC)	17	11/03	330	8.6	13	3.5	+20	Technology
Averages			**1,070**	**5.8**	**13**	**5.7**	**+35**	

**Ratio of operating expenses including management and incentive fees, interest expense and other operating expenses to average total assets for most recent year.*
NC = not computable; the BDC had negative earnings.
E= estimate.
Exchange Key: M=NASDAQ National or NASDAQ Small Cap Market, N=New York Stock Exchange.

Sources: Bloomberg as of April 18, 2007; SEC filings, company Web sites.

advisor to think long term. Secondary offerings may follow, complete with a prospectus and roadshow. The shares will initially trade at or close to net asset value (NAV) per share.

Like mutual funds, BDCs are regulated and usually must meet the following guidelines:

- Invest at least 70% of assets in certain types of investments (70% basket).
- Provide significant managerial assistance to portfolio companies.
- Meet certain asset diversification tests.
- At least annually distribute almost all net investment income and net realized capital gains to shareholders, who are taxed on the distributions at their own rates. Distributions are often made quarterly and shareholders receive a Form 1099-Div showing the breakdown between net investment income and net realized capital gains.

BDC Benefits

BDCs offer a number of benefits to investors, including:

- ***Liquidity.*** There is no need to put up a $5 million minimum and make a 10-year commitment (lockup) here. As Table 1 shows, most BDCs trade at less than $30 per share.
- ***Attractive dividend yields.*** Since BDCs must distribute almost all of their net investment income and net capital gains, yields can be attractive, often in the 6% to 9% range. However, generally the distributions do not qualify for the lower qualified dividends tax rate, so if you're in a high tax bracket, it's often best to put these in a retirement account.
- ***Upside potential.*** Almost every BDC has some element of equity in the portfolio to supplement the income component. Of course, the ultimate payoff is an IPO of one of the portfolio companies. Capital Southwest (CSWC) is a venture capital fund and pays minimum dividends. However, their record is extraordinary, and was achieved in part by taking public some of their portfolio positions including Encore Wire (WIRE), Palm Harbor Homes (PHHM) and most recently Heelys (HLYS).

- ***Diversification.*** Most BDC portfolios are widely diversified, reducing the risk.
- ***Professional management.*** By buying into a BDC, you have access to some of best investment minds who have the skill sets needed to evaluate, build and maintain a portfolio of private companies.
- ***Exposure.*** BDCs provide access to alternative investments that aren't widely available through other vehicles in the marketplace and have little correlation to it.
- ***Economies of scale.*** Costs of high-priced attorneys, consultants, advisors and bankers can be spread across many deals, making transactions more cost effective.

BDC Risks

There are, however, significant risks you should be aware of, over and above the typical risk of stock market investing. These include:

- ***Conflicts of interest.*** If the BDC is externally managed (see question #8 in the following section), it's usually just one of several vehicles managed by a particular advisor. They may also manage institutional accounts, limited partnerships and personal/employee accounts in addition to the BDC. When a choice investment is found and there's not enough to go around, into which investment bucket does it go? It doesn't always go into the public vehicle.
- ***High fees.*** Top investment talent commands top compensation and BDCs are no exception. A typical private-equity fee structure is 1% to 2% of assets under management, plus 20% to 25% of any profits upon sale of an investment. Throw in interest on borrowing and other operating expenses, and the expense ratio can mushroom to 4% to 6% or higher. Incentive compensation tied to a portfolio's performance may also result in riskier investments in an effort to maximize compensation.
- ***Small-company risks.*** As mentioned before, targets typically can't get financing through existing channels because of the risks or costs involved. Small companies often have limited customers, product lines, marketing budgets, distribution channels, management talent and financial resources, and they are more vulnerable to economic downturns. The risk of bankruptcy or default is higher, and the entire investment could be lost.
- ***Fair valuation.*** Since virtually all investments are made in private companies, there's a degree of uncertainty regarding the carrying values of portfolio investments. Having investments valued accurately is essential to maintaining the integrity of the underlying net asset value. We know of one BDC that collapsed from $12 to $2 in one year after investors discovered many of the investments were overvalued based on optimistic assumptions. Another is being investigated by the SEC and U.S. attorney's office and has been under assault by short sellers regarding over-valuation issues.
- ***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. This can be exploited by purchasing shares of high-quality BDCs at a big discount to net asset value, and then waiting for the turmoil to subside and the discount to narrow. As can be seen from Table 1, most BDCs now trade at significant premiums to net asset value, reflecting investor enthusiasm for these securities.
- ***Bad deal risk.*** The market for private-equity investments is highly competitive and the risk of overpaying can turn a good investment into a mediocre one.
- ***Borrowing risk.*** Most BDCs borrow money, which magnifies the potential gains or losses on amounts invested. Changes in interest rates may affect cost of capital and net investment income. Losses on portfolio investments may trigger covenant violations on the credit facility and reduce or eliminate the potential for further borrowings.

How to Evaluate a BDC

If you are interested in testing the BDC waters, here are some questions you should answer when evaluating individual BDCs. Most of these questions can be answered by reading the BDC's annual report, 10-K and proxy.

1) Who's the advisor and how much stock do they own?

As with other investments, we like advisors who are also owners and have their wallets (or pocketbooks) on the line every day as we do. The higher their share ownership, the better. We own preferred shares of Ameritrans Capital (AMTC) where the insiders have sizeable equity ownership.

2) What's the compound annual return over at least five to 10 years, including appreciation and distributions?

When examining annual returns, make sure you consider distributions, which can be an important part of a BDCs total return. One of the best is Capital Southwest (CSWC) run by Bill Thomas, which has generated 14% to 15% returns over the last 45 years while charging shareholders 0.5% of assets. Bill is retiring in July 2007, but his replacement, Gary Martin, has been there 35 years and in our opinion has the qualifications to continue CSWC's fine long-term record.

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 high ratio if the advisor has the skills needed to generate consistent, above-average returns over the long term.

4) Is the fund leveraged—does it borrow to enhance returns?

By law, BDCs can only borrow an

amount equal to their equity capital (i.e., $50 million in equity capital will support $50 million of debt capital). Given the risks involved with target companies, we prefer BDCs that borrow prudently and keep their balance sheets unleveraged.

5) Are you comfortable with the underlying investments?

For example, two of the BDCs in Table 1 invest only in technology. Another two invest only in energy while another two make mostly SBIC (small business investment company) loans—including the financing of taxicab medallions, which can be very valuable assets. If you're concerned about any of these industries, take a look at the more diversified BDCs.

6) How concentrated are the investments?

Some BDCs have a large portion of their assets in a small number of investments. The top 10 positions might represent 30% to 50% of assets. Others are more diversified with a large number of positions, which helps reduce the risk.

We prefer BDCs where the advisor is actively involved in making the investments succeed. We own shares of MVC Capital (MVC), which often takes board seats in target companies to assure they have a continual say in how the business is managed.

7) What's the distribution payout ratio?

To attract and maintain an investor base, many BDCs pay out more in distributions than they earn. The difference is a return of capital, and over time the net asset value will be eroded, which is not good for shareholders. In evaluating a BDC, always make sure they're not paying out more than they earn.

8) Is the BDC managed internally or externally?

Initially, most BDCs were managed internally by a group of analysts and portfolio managers who were on the BDC's payroll and could not evaluate or make investments for any other party. They were dedicated solely to the BDC and its shareholders.

Nowadays, many BDCs are externally managed and have no employees. The board of directors enters into an advisory agreement specifying fees and terms with an external advisor on behalf of the BDC and its shareholders. This is less advantageous to the BDC's shareholders, since the advisor is free to provide its expertise to other parties, leading to potential conflicts of interest. Always check the related party transactions and legal proceedings in the SEC filings.

Conclusion

Clearly, BDCs aren't for the faint of heart. Most offer liquidity, income, upside potential, professional management and the opportunity to invest in some attractive areas.

But there are significant risks, including high fees, leverage, conflicts of interest and risky underlying investments, to name a few.

Most BDCs have Web sites where you can find information on types of investments, advisors, leverage employed, expense and payout ratios, distributions, and other important data. All file documents with the SEC. Needless to say, you should read very carefully all of the filing materials, including the prospectuses, proxy statements, annual and semi-annual reports as well as their 10-Ks, 10-Qs and 8-Ks (detailing material events).

A list of BDCs can be found at www.quantumonline.com, under the "Stock Lists" section (free with registration). You can also find information on BDCs at www.wall-street.com under "venture capital funds, BDCs and private placements" (in the Site Map).

Take the time to analyze and identify those you want to own at the right price. Then when the time is right and the shares are trading near net asset value, make your move. While it's ego gratifying to invest with the big guys, don't pay up for mediocre performance or greedy managers.

Happy hunting. ➤

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