Why BDCs Matter (Part One)

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This past summer we ran a four-part series on collateralized loan obligations ["Why CLOs Matter"]. The excellent response to that special report encouraged us to publish another white paper, this time on business development companies.

We will simultaneously be coming out with interviews with top players and experts in the BDC space. This week we begin a two-part conversation with Jonathan Bock, a recognized BDC guru with Wells Fargo. It makes for compelling reading.

[Sneak preview: Jonathan and his team are hosting the 2nd Annual Wells Fargo Middle Market / BDC CEO Leadership Forum on November 18. This is the "must attend" event for anyone interested in learning more about the middle market/BDC space – link to pdf.]

First, a little history. BDCs were a creation of Congress in 1980 to give small and medium-sized companies more access to debt capital. This regulation supplemented the 1940 Investment Company Act ("40 Act") that already governed investment vehicles such as closed-end and mutual funds.

Under the new rules BDCs had to meet five tests. They are:

1. Maximum total debt to total equity ratio of 1:1
2. 70% of investments must be to private, or thinly traded companies
3. 90% of the income must be dividends, interest, and realized capital gains
4. 90% of that income must be distributed to shareholders
5. BDCs must provide assistance to the borrowers' managers

But a truly distinguishing feature of these companies, compared with other investment vehicles, is they afford *retail* investors the opportunity to buy *stock* in the funds. This contrasts with, for example, many private equity or mezzanine partnerships which offer shares to only institutions or high net worth individuals.

For the BDC manager, a significant advantage is the long-term nature of the capital. Once the fund is raised, typically through an IPO, the manager generally has permanent access to public capital. Even for non-publicly traded funds, of which there are a few, the lock-up is longer than, for instance, the typical investment period for CLO's.

And regardless of whether the BDC trades publicly or not, as a 40 Act entity it is required to file quarterly and annual statements with the SEC. That's a level of transparency which also compares favorably to loan securitizations and other private credit.

As the overall market share of banks has retreated from leveraged lending over the past two decades, BDCs and other less-regulated entities have picked up the slack. That trend has grown since 2001, accelerating particularly with BDCs since the Great Recession (see *Chart of the Week*).

Over the next several weeks, we will explore key aspects of BDCs, including the type of investments they engage in, the role of the BDC manager, and what questions investors ask when considering which BDCs to buy.

But first we'll take a closer look at the structure of a BDC itself.