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Lead Left Interview – Jonathan Bock (Part 2)

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This week we continue our conversation with Jonathan Bock, CFA, Senior Analyst, Wells Fargo Securities. Jonathan is one of the foremost experts on BDCs in the banking industry / research community. The BDC Almanac (his primer) and the Wells Fargo BDC Scorecard (his quarterly) are the most read research reports in the market today. ***Second of two parts –*** ***View part one***

TLL: *How do you distinguish between publicly traded BDCs, and private ones?*

JB: Publics are easy; they trade publicly. The private (or non-traded category) is a little different. These are BDCs that do not trade, but file public financials. Often we'll see managers raise either private institutional capital (TPG) or private retail capital to build a fund they will eventually IPO/list. It's a very attractive way to bring a BDC as it can ease the 3% rule issues on the mutual fund community.

TLL: *How so?*

JB: 40 Act funds are limited to owning only 3% of another 40 act fund. Remember, BDCs are 40 Act funds. So for a $100 million public BDC, a mutual fund manager can only own a $3 million position—that's not very attractive if you run a $7B small cap portfolio. But for a $1 billion BDC seeded privately via institutional capital, a fund manager could buy up to $30 million when that fund is taken to market. That is much more palatable.

TLL: *Why haven't there been more privates?*

JB: They're hard to do. There are few platforms that fund raise *and* invest enough dollars to fill $1 billion. Plus the market isn't favorable now to ramping yield assets. Some may be trying it…but we both know it's not a great time to be investing at yields in excess of 11%+—that puts you squarely in 2nd lien/ subordinated debt.

TLL: *How would you contrast CLOs with BDCs as tools for asset managers?*

JB: BDCs have less leverage (1/1 debt to equity) and focus on much more proprietary assets. CLOs carry higher leverage (8-10x) and generally focus on more liquid securities. What I love about a BDC is that it is truly permanent capital and it often carries much lower transaction costs than moving in/out of CLO paper. That said…the returns are not the same. BDCs don't provide meaningful upfront cash distributions to the same degree as a CLO equity will.

TLL: *Where do you see the BDC space five years from now?*

JB: Bigger…better. It will certainly grow. You can expect it will follow the growth trajectory of other asset classes like REITs and MLPs. BDCs are the last bastions of truly stable yields. You can maintain cash flows through cycles-if a manager knows what they are doing. I'd also expect to see more differentiation. There are good and bad managers out there (just like anywhere) and the market catches on to who is and who is not—it's not that hard.

TLL: *What kind of growth trajectory are you talking about?*

JB: Well, two years ago BDCs had $24 billion in AUM; today, they're over $50 billion. I'd expect to see a similar growth trend in the future.

TLL: *What happens to less qualified managers?*

JB: Good managers (who actually care about fiduciary responsibility) will attract shareholder capital, the poor ones won't. I think the critical question eventually all smart investors ask managers about a vehicle is: "Is this being run for *my* benefit, or yours?" For those who chose to run the BDC for the benefit of anyone else than the shareholder—I'd imagine that the market will keep their valuation discounted to the rest of the industry (i.e. price below NAV).**TLL:** What's been the biggest surprise you've had market-wise this year?**JB:** We're at a watershed moment for BDCs-in Q1 TPG's BDC (TPG Specialty Lending – TSLX) is a great example. Here we have a strong manager raise capital (privately) for several years and then choose to raise some additional public capital via IPO. Institutional interest in this transaction was higher than I have ever seen it—largely due to the managers' quality. Most BDC IPOs go majority retail…and it was great to see this BDC and others "buck the trend".

TLL: *That was certainly a great outcome for TPG.*

JB: It was…but there is a bigger item at play. TPG raised this capital at a time when the space was getting shellacked due to the Russell Rebalance. The market weighed in on quality with TSLX and was rewarded for it. Getting enough size and scale, they were able to generate better than average yields. That translates into strong returns.

TLL: *Given the recent market correction, are BDCs still a good value?*

JB: Yes. First let's play the game of relatives. On a relative basis compared to other yield product (HY/REITs/MLPs) BDCs offer a very compelling valuation. On an absolute basis…BDCs will not provide the same returns as they did off their 2009 lows…but who said that's what they need to do? Investors today can earn 9-15% (name dependent) on high quality, directly originated, 1st lien senior debt—*senior debt that has staying power throughout credit cycles*. I'll take that collateral quality argument any day over a high growth, high multiple story. And my guess is…the market will as well.***TLL:*** *What's the best way to stay up on the BDCs?***JB:** The work we produce at Wells Fargo is a great start. We make it a point to publish the most comprehensive sector/company write ups out in the market—honestly, our motto is "Death by Data". I'm always, always happy to add people to the distribution…just write me at jonathan.bock@wellsfargo.comand I'll any TLL client to the list. You're readers are the best in the industry Randy…and it'd be an honor to help them on the BDCs.

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