Lead Left Interview – Greg Mason and Troy Ward

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This week we speak with Greg Mason and Troy Ward, managing directors with KBW's North America Equity Research team. Messrs. Mason and Ward specialize in business development company research.

The Lead Left: *Guys, really appreciate your time today. What's your current view of the BDC space?*

Greg Mason: Thanks, Randy. The long-term view is that the BDCs have the regulatory winds at their back. Regulatory issues plaguing the financial world are pressuring their competitors, not BDCs. Banks, for example, are dealing with capital allocation problems, leveraged loan exposure, increase in capital regulations…all actions telling banks not to lend! The CLO space will be hampered over time with the new risk retention rules. Add to all this the outflows from retail funds, which are the third largest holders of leveraged loans.

Troy Ward: There has been considerable discussion over the past 12-18 months regarding expanding leverage at the BDCs from 1:1 to 2:1. While the proposed legislation, we believe, is on hold till 2015, we do believe the industry will continue to grow to fill the void left by CLOs and banks. Regulators are not overlooking the BDCs; they are not the focus because BDCs are a smaller industry player and have low leverage. No lender to BDCs has ever lost a penny; No BDCs has gone bankrupt; one of the values of low leverage is lower regulatory focus.

TLL: *I guess even American Capital and Allied ended up getting resolved back satisfactorily.*

TW: Yes, all lenders of both Allied and American Capital were paid in full plus default interest. Those two entities were some of the most stressed in the sector and Allied was acquired by Ares and American Capital reached an agreement with its lenders where all debt was fully repaid.

TLL: *Are BDCs the new CLO?*

GM: Strategically, the same managers will also look to develop BDCs, but there are three keys to success. First, having a good brand and a good track record. Second, coming to the market with a portfolio already built. Investors aren't enthusiastic about blind pools. Finally, making sure that the fee structure that is appropriate and aligns the management team with shareholders.

TW: That last point is critical. Managers can win, but shareholders have to win as well. For example, calculating incentive fees to the manager based on total return that includes a high-water mark (principle value must count), not just income generation, is a must.

TLL: *Do BDCs which focus on junior debt strategies have to deal with more competition?*

TW: It's all competitive! Everywhere! Whatever your strength is, that's what you should focus on. For example, PennantPark has been pretty clear that they are focused on higher yielding subordinate investments; however it's not a great investing environment for those assets so they are waiting and taking it slow. They are sticking to our knitting even if it means investing is slow in the near-term.

GM: In this market, when it comes to labels like “senior” or “junior” debt, you should throw out the nomenclature. A manager like Golub will invest in senior debt yielding 7.5%. But a firm like Triangle will also invest in “senior,” but it’s earning 13%. Both assets are senior but the yield on the asset will tell you more about the risk profile then the name assigned to it.

***TLL:** And fees are higher for higher yielding strategies.*

GM: Fees should be different based on asset focus and some BDCs are lower cost because they are focused on lower yielding assets. However the fee construct is not perfect; there are higher cost BDC’s that have gravitated toward more senior lower yielding assets which doesn’t really justify the manager’s fee and the high cost versus the income generation produces sub-par returns.

***TLL:** How do you contrast BDCs that focus on junior debt investments from the senior debt funds?*

TW: Examples of senior debt floating rate BDCs are Pennant Park Floating Rate Capital, American Capital’s Senior Floating fund, and the Solar Senior Capital fund. The biggest difference is they’re going after liquid loans. Due to its fee structure, most BDCs don’t invest in senior debt, liquid floating credits. For most BDCs the cost structure is 3.5-4.0% so the lower yielding floating rate assets don’t generate enough return; in contrast the floating rate BDCs have a 1.5-2.5% cost so the lower yielding assets can generate a more attractive risk-adjusted return.

GM: The seniors should benefit from the retreat of CLOs being pressured by risk retention rules. On paper the senior floating rate BDC seems like a very good structure, especially with a 7-8% return to the shareholder, but it hasn’t found a huge audience for that paper. We don’t see a lot of new entrants. Public values haven’t caught up; they’re still less than book.

To be continued the week of Nov 10

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