Lead Left Interview – Greg Mason and Troy Ward (Part 2)

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This week we continue our conversation 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.

Second of two parts – View part one

The Lead Left: *What about financing costs? How do lenders to a BDC figure out what to charge?*

Troy Ward: It's very much differentiated by manager. You can't rely solely on bank revolvers, you need a variety of back-stops including unsecured notes and securitizations. Ares just did a five-year unsecured note at 4%, as did FSIC (GSO/Blackstone). Smaller managers are issuing at 6-7%. Golub can do a securitization with AAA's priced at L+175 and be match-funded against the life of the assets.

TLL: *What's the outlook for new BDCs this year?*

Greg Mason: Unless the BDC sector sees a big improvement soon, I don't think there will be any IPO's until 2015. BDC stocks have gotten hammered of late; these stocks are trading below NAV (net asset value). I suspect there will be a smattering of secondary offerings. Fourth quarter asset originations is always busy and thus so is equity issuance; although this year will be tougher given market volatility. New Mountain just got one off and we could see a few others.

TLL: *Why are they trading so low?*

TW: There's a fear that the book values of BDCs will follow where the high yield market has gone; we believe that fear is well overdone. Because of the 1:1 BDC leverage, a three percent drop in high yield values is equivalent to a six percent decline in BDC equity. However BDCs do not hold liquid assets and BDCs didn't mark their assets up above par over the past couple years the way high yield managers do so there will not be a big downside to BDC asset values just because HY is coming down from historic highs.

GM: A bond may trade at 110 because market rates have dropped since the issue came out making the yield on that bond more attractive (trades at premium). BDC assets did not get marked up to 110 and we don't expect book values of BDCs to go down meaningfully due to the recent volatility in the liquid markets. With the pull-back in BDC equity values there are good names that represent buying opportunities; investors should focus on quality managers.

TLL: *Plus these stocks have expectations of 10% dividends.*

GM: Golub's yield is lower – in the range of 7-8% – because of its high quality reputation. People are willing to pay up to own the stock. Ares is trading with a 9.5% yield. There are certainly BDCs with higher dividend yields, but that may indicate the dividend level can't be sustained.

TLL: *But then it comes down to the credit quality of the fund.*

TW: Yes, long-term credit will rule the day and we believe BDC credit is better than most investors may be aware of. We looked at the credit performance since mid-2006 of the fifteen or so BDCs who have been around that long. Annualized losses amounted to 0.65% (<1% annually). That return doesn't include any interest or fee income, just the performance of principle. It does includes positive returns a BDCs had if they took equity in debt exchanges which can help make up for loan losses but that is part of the BDC philosophy which is to be an active investors in credit which sometimes means taking an asset through a work-out to protect the investment.

TLL: *Those are pretty good outcomes. Why have they performed so well?*

TW: They're cash flow lenders, not asset-based lenders. BDCs know they have to understand the businesses they lend to. They have to know exactly what the downsides are. With limited collateral assets, they will likely lose a meaningful piece of their $1 of debt if they don't know what will happen if there are problems. The fear of negative consequence has helped keep strong BDC underwriting.

GM: And compare BDC performance with comparable high-yield losses of 1.80% over the same period. That's nearly triple the loss rate. And high-yield is yielding 6% while BDCs are yielding 9-10%.

TLL: What's been the biggest surprise for you guys in this market?

TW: I guess we keep wondering how long the strong credit quality can be maintained at current levels.

GM: There will be a short-term push by CLO managers to create new vehicles over the next two years, before risk retention rules kick in. So that'll create a glut next year and probably heightened competition. Which means 2015 will look a lot like 2014, low credit losses but compressed yields.

TW: Both the number of and assets managed by BDCs will continue to grow. Near-term volatility has created some welcome yield relief for loan investors, but our guess is that won't last and we are modeling for continued tight yields in 2015.

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