Why BDCs Matter (Last of a Series)

THE LEAD | November 12, 2014

We conclude our series on business development companies by answering your questions:

Is it better for a BDC to be internally or externally managed?

The costs of running an internally managed BDC are typically less than externally managed ones. That's because it doesn't pay a fee (which includes a profit margin) to an outside manager, instead covering the salaries and expenses of its own investment staff. On the other hand, externally managed BDCs are often advised by larger firms with other investment vehicles, such as CLOs and separate managed accounts. That breadth gives those firms greater diversity of deal origination and industry research.

How do BDC value their assets?

As public filers, BDCs must show investments on their balance sheets at fair value, not cost. Establishing fair value for generally illiquid assets is, of course, not always an exact science. The type of asset will determine the appropriate technique. Equity value, for example, can be derived using a market enterprise multiple less the debt. Senior loan values may be calculated using discounted cash flows. In conjunction with these approaches, valuation services provide good third-party "marks" on comparable assets.

Must BDCs use rating agencies to rate their loans?

Unlike CLOs, which often are required by investors or lenders to have assets (loans) in their portfolios rated, there is no such requirement for BDCs. However, there are several advantages to having the BDC itself rated. First, a public rating gives investors and lenders a third-party opinion on relative counter-party risk of BDC managers. Second, earning an investment grade rating allows the manager to access the debt market at a discount to lower-rated issuers. Finally, rating changes, or warning of a potential change, alerts investors to any developments impacting the risk profile of the BDC.

Are BDCs better investments than junk bonds?

As our *Chart of the Week* highlights, BDC yields have outpaced those of high-yield bonds consistently since 2010. This is in part due to high fund demand for junk, which has jacked up bond prices and depressed yields. BDCs offer modest leverage on top-of-the-capital-stack assets, which is a compelling proposition from a credit perspective. And BDCs are a dividend-paying investment, which is attractive to many retail investors.

With last week's election results, is it more likely BDCs get approval for 2:1 leverage?

Our contacts in Washington report chances are good for the passage of a BDC reform bill, though hurdles still remain. One is that the CBO assigned the bill (HR 1800) a $85 million net negative to tax revenues, which means it needs to find revenue enhancers somewhere else. And the leverage provision is a controversial one. Stay tuned!

For a look at all four prior instalments of "Why BDCs Matter?" click here.