The New Wave

THE LEAD | November 20, 2014

Maybe it was the high caliber attendees and top-notch panels. Could have been the stellar master of ceremonies and sponsor. Whatever the reason, the Wells Fargo Middle Market BDC CEO Forum may have breathed new life into the leveraged loan industry.

Led by Jonathan Bock, this gathering of gurus spent the day discussing the role of business development companies and what's needed to take the sector to the next level.

Readers of *The Lead Left* who have followed our BDC series over the past five weeks won't be surprised to hear how those companies have infiltrated the world of leveraged loans. But at the conference, panel after panel signaled an evolutionary shift.

With banks in full retreat, CLOs under risk retention pressure, and loan mutual funds fixated on rate expectations and cash swings, BDCs are poised to go from a relatively small ($60 billion) participant, to a more significant deal player over the next decade.

But for these vehicles to become more meaningful, respected principals in leveraged lending –as CLOs for twenty years dominated the space – institutional investors and sophisticated asset managers outlined four conditions:

1. **Build scale** – Scale is tough to achieve with only one vehicle. It's also hard with a small team. Larger firms can field analysts closely covering a broader range of industries. They can also add distressed investing expertise – a critical specialty to take advantage of opportunities when the next downturn comes.

2. **Originate senior yield assets** – There's a big difference between flow names and yield names. Unlike loan mutual funds, which buy when they have cash and sell when they need cash, BDCs invest in middle market loans. You can't find these assets on a Bloomberg screen. It takes close relationships with sponsors, lenders, and investment banks to generate good yielding deal flow.

3. **Focus on collateral value** – Maintaining superior credit performance on its portfolio of loans is just about the whole ballgame for a BDC manager. Middle market vehicles are not trading platforms. They don't underwrite, then sell to zero. They own and build assets to perform through any cycle. That's not easy now, given where we seem to be in this cycle. One middle market veteran pointed out, however, that while leverage is back to pre-crisis heights, it's off a lower ebitda trajectory (*Chart of the Week*).

4. **Manage for shareholders** – Investors in publicly traded BDCs always look for relative value. That means managers need to demonstrate asset growth, higher earnings, and sufficient dividend yield to compete for retail dollars. Successfully meeting those goals (a likely outcome of accomplishing goals #1-3 above) will mean BDCs can match other public alternatives; namely, high-yield funds, REITs, MLPs, and mutual funds.

It will take time to see whether the genuine thought leadership displayed at the conference this week translates to constructive behavior by the broader set of BDC participants. Given the opportunities presented by the changing demand dynamics in the leveraged loan market, the rewards certainly seem worth it.