

Lead Left Interview – Art Penn

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This week we chat with Art Penn, Founder and Managing Partner, PennantPark. PennantPark Investment Advisers—founded in 2007—is a leading investment firm focused on partnering with middle-market companies to provide them with creative and flexible capital.

***The Lead Left:** Art, you’ve had nearly 30 years of experience in middle market debt. Where are we in the business and capital formation cycle?*

Art Penn: Deal flow feels more robust now than it did earlier in the year. First quarter volume tends to be seasonal, thus a little less active. It was definitely an atypical market in January and February. Public markets were in disarray and volumes contracted more than usual. Activity appears to be picking up.

***TLL:** How about the quality of deal flow?*

AP: It’s mixed. Some high quality deals are coming through, but also some less so. The big question, as you posed at the top is where are we in the credit cycle? In the roundtable you and I attended last year everyone was saying “we’re in the seventh inning.”

***TLL:** It’s been a long seventh inning. Are we closer to a downturn?*

AP: This could either be a cycle resetting or a prelude to the resetting. Overall the economy seems fine, with the exception of energy. So I suspect we’ll see an elongation of the current cycle we’re in.

***TLL:** What does the Fed do under these circumstances?*

AP: Today’s news [that the Fed is sitting tight on rates] continues to be helpful. Especially in our space, where investments are in private, illiquid, long-term loans.

***TLL:** Speaking of which, what’s your view of BDCs and the outlook for these vehicles in general?*

AP: BDCs have been doing what they were set up to do about 35 years ago and that is to channel capital to small and midsize companies. Right now the industry is out of favor with institutional investors. Initially that was due to the SEC’s Applied Funds rule, which restricted certain investors from owning BDCs. Then a view emerged that BDCs should trade in-line with other yield oriented vehicles such as REITs and MLPs, which got hurt when investors thought the Fed was going to raise rates. Ironically, most BDCs own primarily floating rate assets which can benefit from rising rates! Lastly, there is a perception that the BDC industry has some “bad actors.” Like with every sector, there are good representatives and not so good representatives. This industry is no different than any other. Capitalism by definition means that capital gets allocated.

***TLL:** Regulation is partly responsible for that.*

AP: Yes, the SEC’s Applied Funds rule has made it difficult for some institutions to own BDCs. That said, given the low stock prices relative to NAV, value-oriented investors are increasing their interest. Nature abhors

a vacuum. The most volatile thing about BDCs can be their stock prices, which can offer terrific entry points for long term investors.

TLL: *Are underlying BDC technicals favorable, in your view?*

AP: BDC share prices currently provide both attractive multiples to book and dividend yields. BDC assets are much more transparent than those of other vehicles, such as bank balance sheets. And BDCs are a lot less levered than banks or some funds. Investors are also getting information on a market to market basis with independent valuations.

TLL: *Is there more resilience in a down economy?*

AP: If the economy contracts down the road, having long term permanent equity capital and multiple sources of long term debt financing will inure to the benefit of BDCs. Also, many of the better managed BDCs are likely to benefit from diversification, given the broad spectrum of industries and sectors they're invested in.

TLL: *Art, tell us how PennantPark's BDCs are structured.*

AP: We have two public BDCs: PFLT and PNNT. PFLT is a senior-focused vehicle with about 88% of its assets in classic first lien secured loans, and about 12% second-lien and other higher-yielding instruments or equity. Yield on the PFLT portfolio is above 8%. With the stock trading at about 90 percent of NAV, that translates into a dividend yield of about 9.4%. As of 12/31, the debt to ebitda on the underlying portfolio averaged about 3.9x.

TLL: *And last summer PFLT purchased another BDC, MCG Capital.*

AP: Yes, the merger nearly doubled our lending capacity, allowing PFLT to make larger investments and be more important to our borrower clients. So that vehicle is in an excellent liquidity position today to deploy capital to our clients.

TLL: *How about PNNT?*

AP: PNNT was envisioned as a sub debt vehicle when we started in in 2007 and today invests in a combination of stretch senior, 2nd lien and mezzanine loans. The underlying portfolio generates a 12%-plus yield and had an average debt to ebitda of 4.8x on its cash flow loans as of 12/31. We're excited about the SBIC licenses in PNNT. Changes in the laws at year end increased the amount that we and other licensees can borrow. We've drawn about \$150 million in SBIC I and have just begun drawing the \$150 million in available capital in SBIC II. With SBIC financing recently locking in an interest cost of about 3% for 10 year financing, we are enthusiastic about utilizing this source of funds.

TLL: *Are there any other fundraising plans?*

AP: We have been operating a subordinated-focused private credit opportunity fund for a few years and today we are actively discussing other senior-focused private vehicles with institutional LPs. Our track record is strong over the last nine years, including through the recession, and we are looking to build long term relationships. We have SEC Exemptive relief that allows us to co-invest across funds.

Contact: Arthur Penn

Penn@pennantpark.com