

Business Development Companies: Lending to the Riskiest Segments of the Economy

FINANCIAL SERVICES SECTOR REPORT

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Investors Attracted to High Yields. Business development companies ("BDCs") have attracted a lot of interest, particularly among individual investors. The popularity can be attributed to the relatively high dividend yields. As yields for fixed-income alternatives have fallen to the low single digits, BDC dividends have become one of the few remaining options for investors who are seeking high income.

But Investment Concerns Outweigh the Positives, in Our View. BDCs invest in risky segments of the economy and the long-term credit performance of the companies in which BDCs invest has been poor. Compared with banks that primarily use deposits, BDCs also use far less reliable sources of financing. As a result, the BDCs have experienced challenges associated with liquidity during recessionary environments, contributing to inconsistent dividends and stock price performance.

We believe that there is a high level of risk associated with owning these stocks, and we do not believe they are appropriate for most individual investors seeking income. Alternatively, we view regional banks as a higher-quality source for equity income in the financial sector.

Key Investment Considerations

- **High Yields, but Driven by Very Poor Credit Quality.** BDCs primarily lend money to small, mostly private U.S. companies that are considered too risky for traditional financial institutions. In some cases, the BDCs will also invest in the stock of these companies. On balance, the quality of these investments is considered very poor, probably below investment grade if analyzed by the ratings agencies.
- **Historically Unreliable Financing.** BDCs rely on banks to lend them money to finance their investments. As credit conditions worsened during the financial crisis, bank lenders reduced available borrowing capacity for BDCs and demanded repayment faster than the BDCs could liquidate their assets.
- **Stock Prices and Dividends Plunge in Recessionary Environments.** Stock prices, earnings and dividends for BDCs have typically come under pressure during periods of economic weakness.

The BDC industry has grown steadily since 1980, but growth began to accelerate in the early 2000s. There are about three dozen publicly traded BDCs today, but only about a dozen of those were publicly traded prior to 2005. Only nine BDCs currently have a market capitalization in excess of \$1 billion, and we estimate that the market capitalization of the entire BDC industry is less than the market capitalization of several individual regional banks that are currently under research coverage (Source: FactSet 10/13/2023).

BDCs are less diversified than most other financial services companies, including banks. Like most banks, BDCs generate most of their revenue from fees and interest income generated from their investments, less interest costs on borrowings. However, BDCs do not operate branch offices, offer checking or savings accounts, or underwrite mortgages or consumer loans. Instead, BDCs operate in a niche sector of financial services, lending money to the type of borrowers ignored by traditional banks.

Investors Attracted to High Yields. Like real estate investment trusts (REITs), income taxes are not paid at the corporate level as long as the company pays out most of its income to shareholders. Even though BDC dividends are taxed at relatively high ordinary income-tax rates, the average yield for the larger, more liquid BDCs is over 10% currently, which is likely to attract the interest of investors seeking current income (Source: FactSet 10/13/2023).

Key Characteristics of the BDC Model. In the following section of the report, we will examine the key characteristics of the BDC model and highlight some of the more relevant risk considerations for individual investors.

Highly Transparent Balance Sheets. Positively, BDCs provide a truly unique level of disclosure when compared with other financial institutions. For each of their individual portfolio company investments, BDCs are required to report the name of the company in which the investment was made, the industry in which the company competes, each individual security, the negotiated yield (if applicable), its original cost basis and current carrying value, or "fair value." Compared with other financial institutions, this is a remarkable level of transparency, in our view.

...But Above-Average Earnings Volatility. For BDCs, investments are initially recorded on the balance sheet at cost. Each quarter, the fair value of

each investment is estimated, which can be greater than, equal to, or less than the original cost basis. After the valuation process is complete, the BDC reports quarterly financial results that reflect the new fair values of their assets. In aggregate, the change in value either increases or decreases reported net income, sometimes by quite a lot. This unusual accounting leads to extraordinary fluctuations in earnings.

Somewhat controversially, valuation processes are not consistent from one BDC to the next. For example, some companies use independent third parties to evaluate the earnings prospects, market positioning and financial strength of each individual portfolio company. Then, the third-party company values the BDC investments based on the use of discounted cash flow or comparable company analysis. Meanwhile, other BDCs may simply designate this responsibility to internal employees, to be reviewed by a committee of the board of directors. In the past, it has not been uncommon for BDC management teams to come under scrutiny for perceived weaknesses in their respective valuation processes.

Investors generally focus on the net operating income of the portfolio, which is mostly captured by the difference between interest income from lending and borrowing, offset by operating expenses including management fees, if applicable. Net operating income is a good representation of the cash flow that is available to support the dividend.

...And Poor Overall Credit Quality. One of the easiest ways for a financial company to achieve higher returns is by investing in low quality assets. Traditional banking institutions are not interested in providing loan products to companies with weak credit profiles. Indeed, bank regulators may actually limit their ability to make loans to these companies, as regulators are primarily concerned with protecting depositors. This is ideal for the BDCs, too, because there is no direct competition with larger, but better capitalized banks.

More often, BDCs partner with private equity firms in buyout transactions. Capital in support of mergers or acquisitions is perceived to be riskier for the lender when compared with loans made to stable, cash-flowing companies. Sometimes, the BDC may even take a preferred or common equity position. Some BDCs argue that the gains achieved from their equity

position can offset their loan losses over time. There is some evidence that the better operators have achieved better results by harvesting equity gains.

Additional Considerations. BDC investment portfolios can be quite different when compared with one another, and these differences can meaningfully impact long-term investment performance. Below we have highlighted the more important measures of portfolio quality.

- **Level of Collateral Protection.** Most BDCs make senior loans. In the event of a bankruptcy, the senior lender is in the strongest position to achieve a full return of invested capital. Meanwhile, in the same bankruptcy scenario, the equity investor could experience a total loss of their investment. BDCs with the largest exposure to equity performed the poorest during the most recent recession.
- **Investment Yield.** For loan investments within BDC investment portfolios, loan yields are highly correlated with risk. Lenders generally negotiate higher yields for weaker borrowers. *It is common for subordinated loan yields to be as high as 12%-15%. In the current interest rate environment, we don't believe that any company would agree to a yield that high unless the company had very few other options.*
- **Portfolio Concentrations.** Investors in the BDC sector may also want to examine if management has made outsized bets within certain industries or in certain parts of the country. Given the high level of disclosure, it is fairly simple to ascertain, for example, if the BDC has a relatively high exposure to cyclical industries such as real estate or financial services.
- **Weakest Borrowers Do Not Pay Cash Interest.** BDCs often agree to somewhat unusual terms because of the low quality of their borrowing customers. Specifically, the BDC may agree to accept noncash interest. Instead of making a periodic interest payment, the outstanding loan amount is simply increased by the amount of interest due. One could argue that this *increases* exposure to a lower-quality borrower over time. It also creates a challenge for the BDC, given that this represents noncash income that must be distributed to investors. Absent some repayments within the portfolio, this income may become so large that the BDC has to raise capital to make the dividend payment.

Limited Financial Leverage Reflective of Poor Credit Quality. To increase earnings and returns,

financial companies can increase their borrowings to make an ever-increasing number of investments. Positively, most BDCs borrow less than 80% of their equity capital. This is far below the typical leverage for financial companies, including banks, which operate with a ratio of 8-12 *times* debt to equity. *In our opinion, the low level of financial leverage used by BDCs is appropriate given the weakness in credit quality that we have discussed. It could even be too high, in some cases.*

External Management Agreements Could Be a Moral Hazard. Many publicly traded BDCs actually have no employees. Instead, they are managed externally, subject to detailed agreements. Typically, the BDC pays a low base fee to the external management company that is fixed as a percentage of equity. In addition to the base management fee, an incentive fee tied to investment performance is also paid to the management company. The management agreements vary from company to company and can be quite complex, but are most similar to the fees charged by hedge fund managers.

In our view, these fee agreements can create a moral hazard. As the BDC takes on greater credit risk or financial leverage, the manager can generate higher dividends for investors and higher fees for the management company. However, should the investments fail to perform as expected, one could argue that the consequences are more severe for BDC investors, as they not only lose their income but may also lose their invested capital.

Debt Capital: Historical Funding Unreliable Hurting Ability to Repay Debt. Historically, the BDCs have relied primarily on borrowings from a small group of U.S. banks. During the financial crisis, the BDCs discovered that their access to borrowing was weaker than they had previously thought.

As many will remember, U.S. banks were facing their own challenges during the financial crisis. As a result, they responded by eliminating unused borrowing capacity with BDCs. Later, as credit facilities reached renewal dates, banks forced the BDCs to agree to pay back their borrowings faster than originally planned. Clearly, the mismatch between the relatively short renewal dates for their lending facilities and much longer maturities of their loans was problematic. BDC loan assets were simply not liquid enough to enable them to respond to the

accelerated repayment plans imposed by their own bank lenders.

Since the downturn, BDCs have improved their financing by diversifying their borrowing among several banks, by extending maturities and by negotiating more favorable covenants. However, we believe that BDCs still have substantially weaker financing when compared with banks.

Equity Capital: Serial Capital-Raising Highly Disruptive and Dilutive. BDCs are required to pay out a substantial percentage of their income to avoid paying corporate-level income taxes. *As with REITs, the inability to retain earnings for growth requires the BDCs to regularly raise more equity in order to grow.*

Valuation Considerations

While the valuation for BDCs may appear attractive, we believe that the rich valuations that BDCs earned at the peak of the last economic cycle did not accurately discount the higher-risk nature of BDCs as investments, particularly for individual investors.

Book Value represents an estimate of the value of the company in a liquidation scenario, assuming that all assets are sold and all debts are repaid. Currently, most stocks in the BDC sector are trading just below estimated liquidation value (Source: FactSet 10/13/2023). Just prior to the financial crisis, the average premium to liquidation value reached 40%. However, widespread concerns about the value and liquidity of their assets as well as concerns about the strength of their financing led the average BDC valuation to plunge sharply, to a *discount* of 70% of reported liquidation value.

Dividend Yield. For most of the larger, more liquid BDC stocks, yields are between 9% and 12% (Source: FactSet 10/13/2023). An important consideration is net operating income, which approximates the cash flow that is being generated by the company. Ideally, there would be more cash flow being generated than is being paid out to investors. If dividends are higher than net operating income, it is likely that the BDC will be forced to lower the dividend at some point, everything else held constant.

Conclusion -- We believe that there is a high level of risk associated with owning these stocks, and we do not believe they are appropriate for most individual investors seeking income. We recommend that

investors consider other financial stocks for current income, such as regional banks. While the yields are not as high as the yields for BDC stocks, we are more comfortable with the long-term outlook for dividends.

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