BDCs – Private Debt with Liquidity

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How might investors access the benefits of private debt whilst avoiding the restraints incurred by traditionally illiquid assets?

Viewpoint

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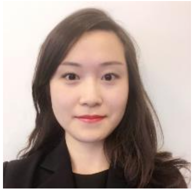
Eric joined Muzinich in 2012 from Cyrus Capital Partners, a credit opportunities firm, where he was a Managing Director. Previously, Eric was the Senior Partner and Portfolio Manager of FriedbergMilstein (a direct debt origination firm), a Partner and Managing Director of JP Morgan Partners and a Managing Director of BNP's Merchant Banking group. Eric started his career at GE Company/GE Capital.



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Ji joined Muzinich in 2017 from JPMorgan Asset Management's fund of hedge fund research and portfolio management group. She started her career in JPMorgan Investment Bank. Ji holds a Master's Degree in Operations Research from Columbia University and a Bachelor's Degree in Electrical Engineering from Nanyang Technological University, Singapore. She is also a CFA charterholder.

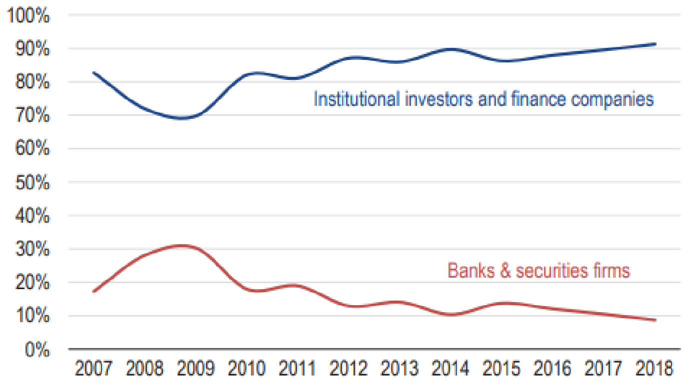
Market Opportunity

Unlike Europe, where non-bank lending (disintermediation) is a relatively recent phenomenon and a direct result of the global financial crisis, in the US it is a different story.

Banking Consolidation

Since the 1980s, the banks have been largely disintermediated from the US leveraged lending market over time. Increased regulatory constraints on US banks have limited their ability to lend to small and medium-sized companies (Fig. 1).

Fig. 1 - Banks' Share of Leverage Loan Market is Shrinking



Source: S&P LCD, " LCD Quarterly Review, 4th quarter of 2018", as of 31 December 2018.

This continued contraction in bank lending and post-2008 regulation has provided a greater opportunity for alternative providers of debt to the US middle market (companies with revenues from US$10mm-US$1bn) through a Business Development Company (BDC) structure.

Capital Market Evolution

While there have been some concerns about the size and growth of this segment of the market, we believe it marks just another stage in the evolution of corporate financing.

The high yield bond market only came into its own during the early 1990s. More recently we have seen the increasing growth of the syndicated loan market, which reached US$1trillion in 2018; an asset class that was initially private bank driven lending has now evolved into a much broader, syndicated lending market. The growth in the private debt market is in turn filling the lending gap left by the larger institutional investors who have moved away from the smaller deals. [1]

With the growth and maturation of the US private lending market, we believe BDCs could represent an attractive investment opportunity for investors who are interested in an allocation to the private debt asset class, but are constrained by the illiquid nature of traditional private debt investments.

A Unique US Structure

A BDC is a unique vehicle designed to invest in small and mid-sized US businesses. BDCs were created by Congress in 1980 as an amendment to the Investment Company Act of 1940, with the goal of encouraging the flow of capital to private, mid-sized businesses in the US.

The structure (a corporate form) has the underlying investments which are illiquid, but the BDC can be listed on a public exchange. This offers investors public market liquidity with the ability to access private debt illiquidity premiums.

There is a private BDC market comprising 87 BDCs and a public BDC market with 50 entities. The public BDCs have a total market cap of around US$30bn.[2]

Alternative asset management firms such as Ares Management, TPG and Goldman Sachs manage BDCs, investing in US small to medium-sized enterprises (SMEs) via directly originated senior secured and junior loans. Each BDC is highly diversified in its exposure to single name idiosyncratic risk with, on average, 120 names within its portfolio.[3]

Favourable Tax Treatment

Like Real Estate Investment Trusts (REITs), as long as the BDC meets certain income, diversity and distribution requirements, the company may pay little or no corporate income tax.

BDCs typically elect to be taxed as regulated investment companies (RICs) under the Internal Revenue Code. This requires BDCs to distribute at least 90% of taxable income annually as dividends to investors. Typically BDCs pay dividends on a quarterly basis.

The PATH (Protecting Americans from Tax Hikes) legislation has transitioned tax treatment to investors' country of domicile tax treaty, thus providing a simpler structure for offshore investors to access the US private debt asset class without incurring effectively connected income i.e. they are not required to pay US income tax.

1. ICE BofA Merrill Lynch Global Research; LCD, as of May 2018.
2. SEC BDC Report, as of 20 July 2018, updated annually; KBW Research, as of 31 December 2018.
3. Muzinich analysis, company reports, as of Q3 2018.

The BDC structure also reduces the risk of 'trade or business' tax concerns related to loan origination activities, as BDCs are US-domiciled entities, which can be a further benefit to non-US based investors.

Regulation

A US corporation may elect to be regulated as a BDC if it meets certain requirements of the Investment Company Act.

Election as a BDC requires the firm to subject itself to all relevant provisions of the Investment Company Act, including:

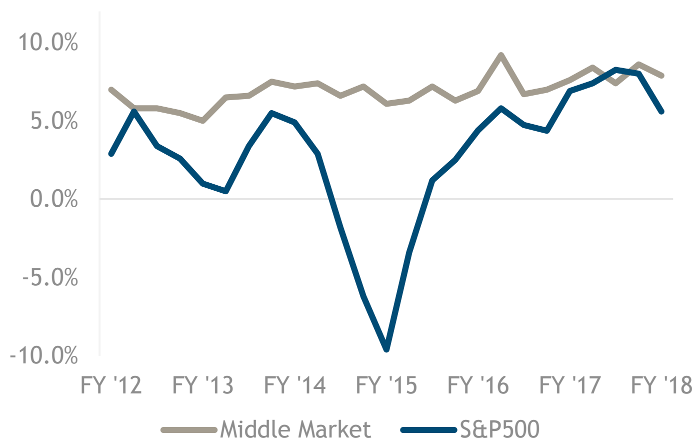
- 70% of assets must be invested in securities issued by private companies or public companies with an equity market cap of less than US$250 million;
- Leverage is limited to 200% asset coverage (i.e., US$2 of debt for every US$1 of equity);
- Oversight by a majority independent board of directors;

BDCs are also required to file quarterly reports, annual reports and proxy statements with the SEC. Both public and privately-traded BDCs are required to make public filings with the SEC.

US Middle Market Overview

There are an estimated 85,000 businesses with revenues greater than US$25mn in the US middle market. The US middle market, where BDCs operate, are enjoying strong growth (Fig. 2), with an estimated 7.9% growth rate over the last 12 months through December 2018, compared to approximately 4.7% revenue growth rate for companies in the S&P 500.[4]

Fig. 2 - US Corporate Revenue Growth



Source: National Center for the Middle Market estimates released Q4 2018.

4. National Center for the Middle Market estimates released Q4 2018. Updated annually.

How the US BDC Market May Evolve

REITs, a similarly-structured vehicle, have shown significant growth over the past 20 years. Like a BDC, a REIT is generally exempt from corporate level taxes.

This tax advantage has contributed to the tremendous popularity of REITs with US investors, but also benefits non-US investors looking to invest in the US.

Today, the REIT market represents US$1 trillion of assets in the US, having grown six times in size over the last seven years. We believe the speed and manner by which the REIT market has grown in the US may provide a good indication of the growth potential for the US BDC market (Fig. 3). The BDC industry has been a key source of capital for direct lending, with total assets amounting to US$90 billion.[5]

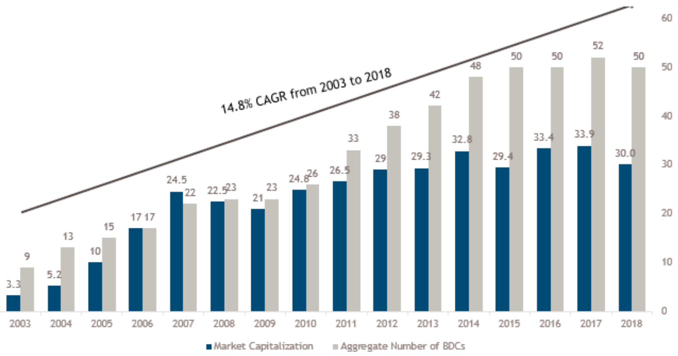
Fig. 3 - REIT Market vs. BDC Market

	US REIT Market	US BDC Market
Established	1960	1980
Public Corp	177	50
Avg. Mkt Cap	US$5.6bn	US$1.0bn
Yield	6.1%	10.0%
Underlying Assets	Real estate properties or mortgages/mortgage securities	Typically private debt of middle market companies

Sources: REIT data points from REIT.com and BBREIT Index, as of 31 December 2018. BDC yield data from "KBW Weekly BDC/RIC Summary", as of 31 December 2018.

The public BDC market has already witnessed meaningful growth over the last 16 years (Fig. 4) with the addition of 41 new BDCs becoming public. There are also 87 private BDCs which may go public over the next few years.[6]

Fig. 4 - Growth in the BDC Market



Source: "KBW Weekly BDC/RIC Summary", as of 31 December 2018.

Potential Advantages of BDCs

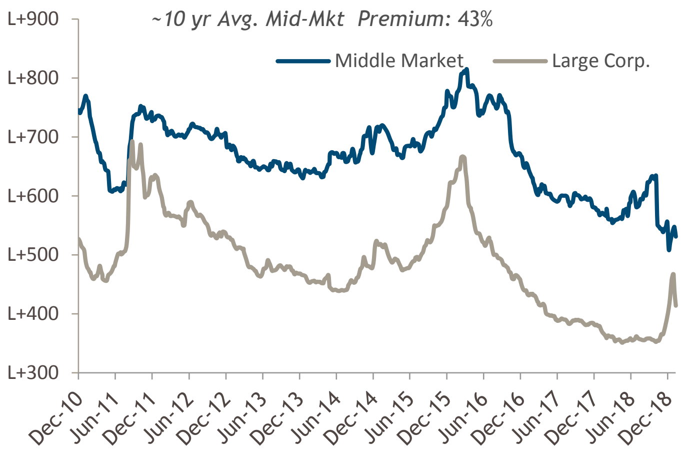
Illiquid Assets, Liquid Structure

Asset managers often have clients that expect to be able to liquidate their investment at very short notice. To facilitate an active secondary market, minimum issue size of US$400mn is required and most investors require over US$1 billion of outstanding bonds, in our view. Therefore, we believe there is no liquid secondary market for the debt of US middle-market companies, given the size of their balance sheets.

The public ownership structure of the BDC (listing on NYSE or NASDAQ) typically allows investors liquidity, while still benefiting from private debt liquidity premiums.

Historically, US middle market loans have provided a 10 year average liquidity premium of approximately 200bps, or 43%, above comparable large cap loans (Fig. 5).

Fig. 5 – Middle Market Illiquidity Premium



Source: S&P LCD Market Intelligence, yields based on Large Cap and Middle Market subset of the S&P/LSTA Leveraged Loan Index, as of 7 December 2018.

Attractive Yield, Floating Rate

The reduced availability of credit to middle-market companies typically results in an increased interest rate for loans to middle-market lenders.

These loans also typically include meaningful upfront fees and certain prepayment protections, both of which enhance their profitability to investors.

The typically floating rate nature of pricing may also provide a meaningful level of protection from increases in interest rates. BDCs may benefit from a rising rate environment as higher rates enhance earnings as the majority of the underlying assets are floating rate loans.

Attractive Valuation

BDC prices tend to fluctuate within a band as they are effected by the macro economy, credit cycle and investor sentiment. (As highlighted in Fig. 6, 82% of the time, the WFBDC Index has traded with in 0.9x~1.1x band.)

As a result, the volatility of the BDC index can be meaningful. Nevertheless, investors receive dividends which can be around 8-10% per year, which can help reduce the volatility.

We believe current valuations offer an attractive entry point into the BDC market.

5. Source: S&P LCD, as of 31 January 2019.
6. Source: SEC Business Development Company Report, as of 20 July 2018, updated annually.

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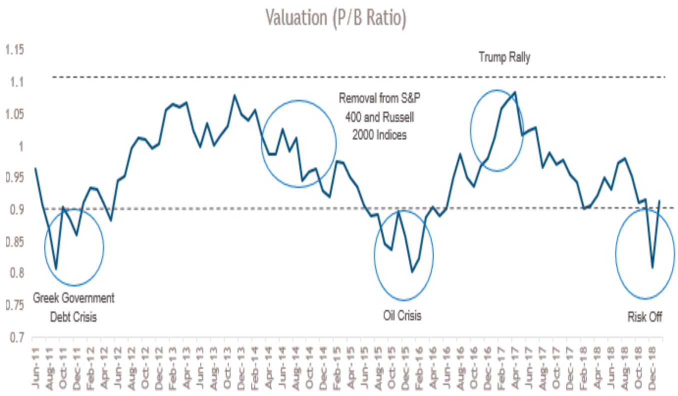
Fig. 6 - BDCs Have Historically Traded in a Valuation Band

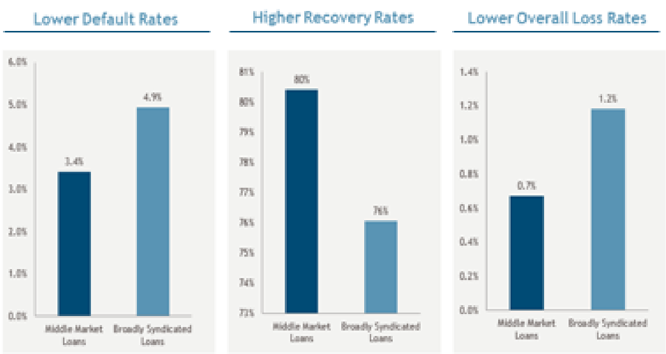


Source: Bloomberg, WFBDC index as of 24 January, 2019. For more index descriptions, please see Important Information at the end of the presentation. The index valuation is available on Bloomberg starting June 2011.

Lower Default Risk, Higher Rate of Recovery

Loans to US middle-market companies have exhibited lower default rates and higher recoveries when compared to broadly syndicated loans. Historically, middle market loans have presented low correlation to other major asset classes.[7]

Fig. 7 – Lower Overall Loss Rate



Source: TIAA Global Asset Management Private Debt: The opportunity for diversification with illiquid assets. Summer 2016. Middle Market Loans defined as loans of $200 million or less, based on S&P LSTA Leveraged Loan Index; Broadly Syndicated Loans defined as loans greater than $200 million, based on S&P LSTA Leveraged Loan Index; Average default, loss, and recovery rates are based on trailing 12-month time frames. The default is defined as 1) The company files for bankruptcy; 2) The facility gets downgraded to D by S&P (not due to below par buybacks); 3) The interest payment is missed without a forbearance. S&P LCD, S&P Credit Pro, BoA Merrill Lynch. Measurement Dates 1998–2015, as of 30 June 2016.

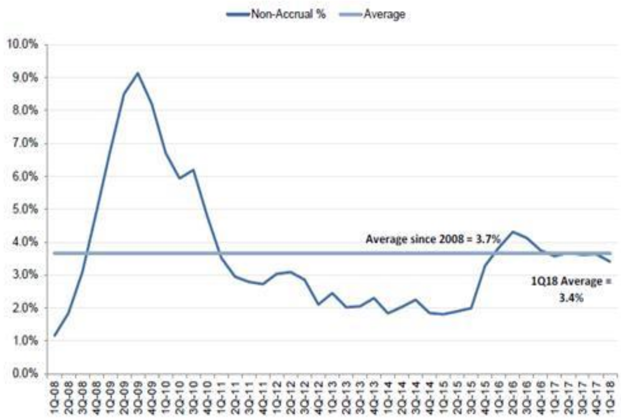
In addition, these loans are marked to model by third party valuation agencies on a quarterly basis and lenders will often work with their borrowers to manage through financial difficulty. Also, in contrast to the broadly syndicated market, middle-market transactions are typically structured with lower leverage, stronger documentation and tighter covenants.

Healthy Fundamentals

In our view BDC fundamentals appear healthy within a sound US economy with robust revenue growth in the middle market, as demonstrated by low non-accrual rates. As these businesses are mostly domestically focused, their revenues should also not be significantly affected by potential trade wars.

7. Source: S&P Capital IQ for data between 2005 and 2015.

Fig. 8 - Level of Non-Performing Loans in Public BDCs



Source: KBW North American Research, as of 20 June 2018.

Recent Legislation

We also believe BDCs should benefit from recent changes in legislation (the Small Business Credit Availability Act) and the regulatory environment, which has allowed them to increase leverage ratios to 2:1 from 1:1 subject to investor approval. In our view, this is a potentially positive catalyst for higher earnings and return on equities.

Conclusion

While private debt continues to appeal to a broad spectrum of investors, the illiquid nature of such investments can prove too high a barrier to entry for many investors.

BDCs, with their daily liquidity, high dividends, favourable tax benefits for offshore investors, healthy fundamentals, low default rates, higher yields and floating rate nature, despite their price volatility, can be an interesting alternative for investors considering an allocation into private debt.

However, BDCs are relatively unknown to the European investor base and therefore we believe it is important to choose a manager with the right skillsets and experience in BDC investing.

A long tenure in the US middle market is, in our view, key to creating a strong relationship network, a deep understanding of the market segment and the development of extensive experience in dealing with BDC management teams.

Index Descriptions

S&P 500 - The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.

Wells Fargo Business Development Company Index - The Wells Fargo BDC Index (WFBDC Index) is a capitalization-weighted index capturing the total return of all lending-oriented, exchange-listed Business Development Companies (BDC) that satisfy certain eligibility requirements. You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of an investment.

Bloomberg Real Estate Investment Trust Index (BBREIT) – A capitalization-weighted index of Real Estate Investment Trusts having a market capitalization of $15 million or greater. The BBREIT index was developed with a base value of 100 as of December 31,1993. The index is rebalanced semi-annually in February and August.