

Business Development Companies

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Agenda

- What is a BDC?
 - How is it different than a REIT?
- How to Evaluate a BDC
- How BDCs have performed relative to bond indices
 - NOT the S&P500
- An Example BDC: New Mountain Finance Corporation (NMFC)
- Conclusions

What is a BDC?

- Wikipedia:
 - Established in accordance with the Investment Company Act of 1980
 - A company that makes loans to small and mid-size businesses
 - Regulated by the SEC
 - Distributes 90% of net income to investors to avoid paying income taxes
 - Similar to a REIT, but assets are loans to companies
 - NOT Private Equity or Venture Capital
 - Most BDCs are publicly traded – some are not
- Primary reason for investing: High dividend with diversification
 - Can result in very high returns in a buy and hold portfolio, with a Dividend Reinvestment Program (DRIP)

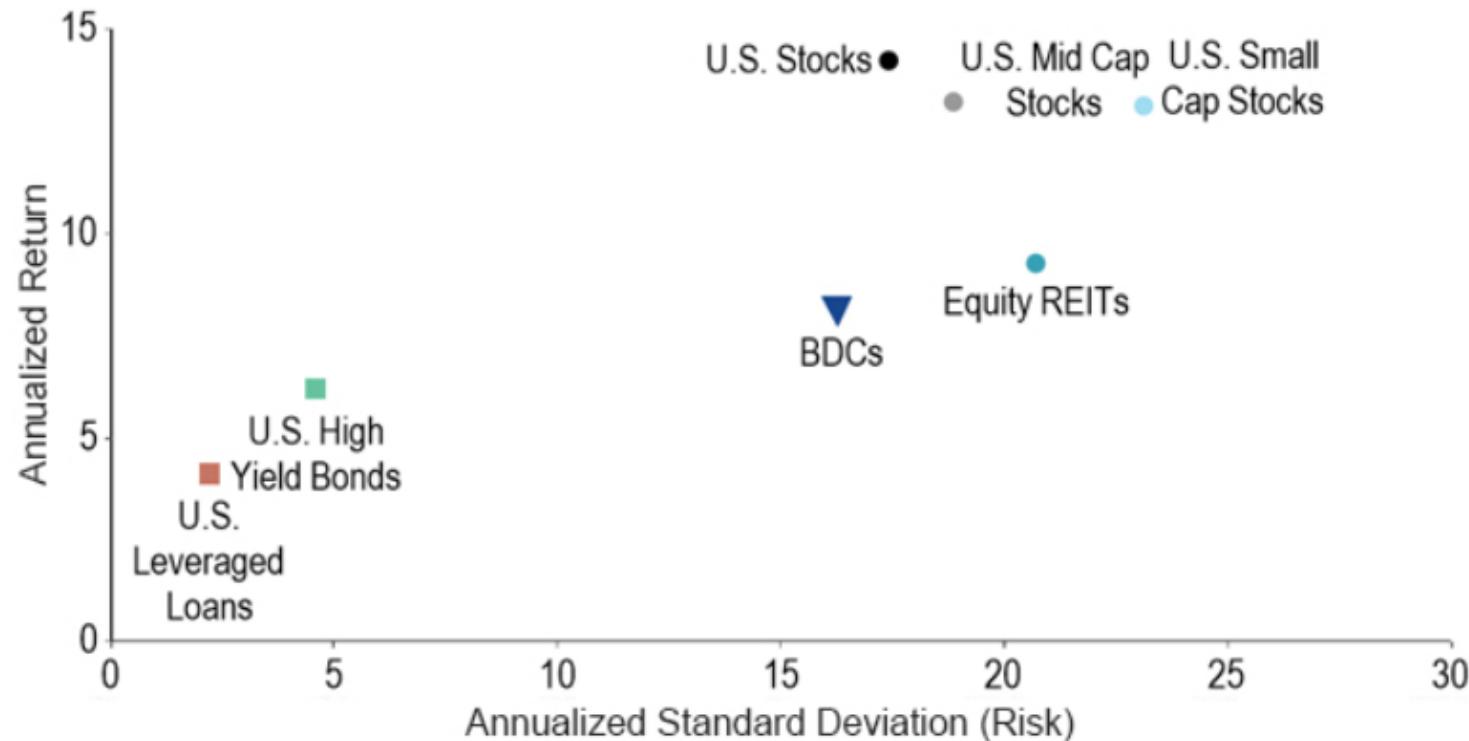
The Case for Investing in BDCs

- Tailwinds: Tax reform and the Small Business Credit Availability Act (2018) increase in leverage limits
- No double taxation! (Taxes they would have paid are paid out in dividends)
- Average 9.6% dividends, quarterly or monthly
- 80% of portfolios consist of floating rate loans
 - Protection against rising interest rates
 - Borrow at low fixed rates, and lend out at high floating rates
- Portfolio quality is improving and yields increasing
- BDCs under valued but gaining strength in the past 3-4 months
- Bankruptcy among BDCs extremely rare
 - Interest payments take precedence in the event of customer default
- Dividend Reinvestment Programs (DRIP) are powerful incentives for investing
- Headwinds: S&P has recently put the BDC market on credit watch

BDC Market Risk vs. Reward

Annualized Standard Deviation versus Annualized Return (%)

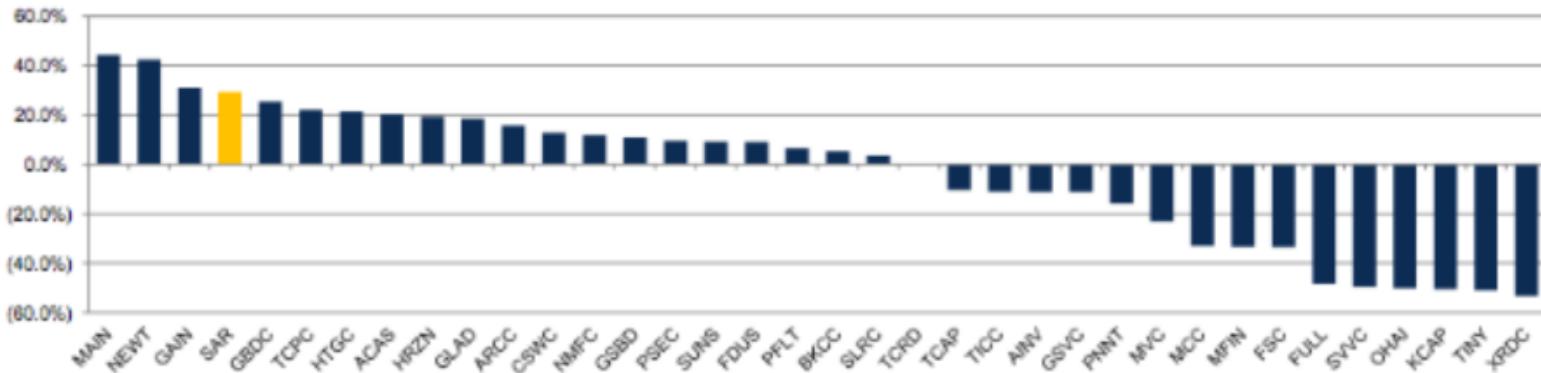
8/4/2011 – 5/31/2018



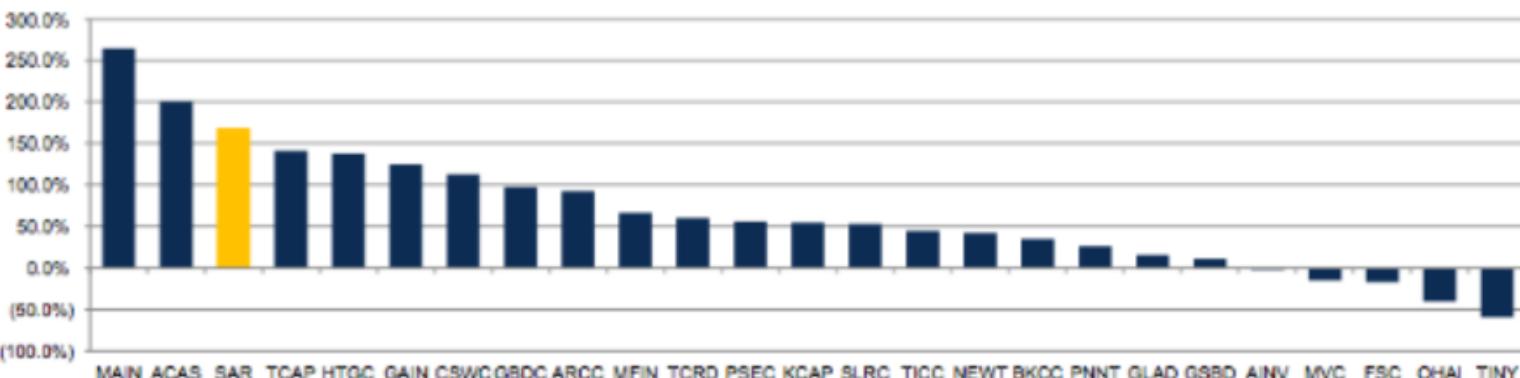
Source: FactSet, Bloomberg. Data as of May 31, 2018. Past performance is no guarantee of future performance. Index performance is not indicative of fund performance. Indices are not securities in which investments can be made. See index descriptions and additional disclosures below.

Total Returns Can Vary Widely

BDC Total Return (%)
(June 2013 to June 2016)
SAR – 29.4% over 3 years



(May 2010 to June 2016)
SAR – 169% over 6 years



Source: Saratoga Investment Corp

How to Evaluate a BDC

The success of any REIT or BDC is directly tied to how much debt they take on

- Is the dividend sustainable?
 - What is the dividend history? Increasing dividend is excellent
 - Calculate Dividends / Funds from Operations (FFO) – should be <1.0
 - Calculate Debt to Book Value – varies, but should be < 50%
 - >100% is a bad sign
 - Calculate Cash Flow Yield – FFO/NAV: 10% or more is good
- Financials: Are Net Asset Value, Revenue, FFO increasing?
- What is the quality of the portfolio?
- Does the BDC focus on a particular business sector?

How to Evaluate a BDC, cont'd

- Is the BDC externally managed? Or internally?
- Insider holdings?
- What are the qualifications of the managers?
- Who are the major investors / holders?
- Analyst opinions?
- Check Relative Strength Index (RSI) - look for dips
 - If < 20: buy it
- Short interest?
- What is the BDCs sensitivity to economic cycles? Beta?
- Do they have a Small Business Administration guarantee / license?

Largest BDCs

Note: There are approximately 50 BDCs registered with the SEC

- [New Mountain Finance Company \(NMFC: NASDAQ\)](#)
- [Apollo Investment Corp. \(NASDAQ: AINV\)](#)
- [Ares Capital Corp. \(NASDAQ: ARCC\)](#)
- [BlackRock Kelso Capital Corp \(NASDAQ: BKCC\)](#)
- [Fifth Street Finance Corp \(NASDAQ: FSC\)](#)
- [FS Investment Corporation \(NYSE: FSIC\)](#)
- [Gladstone Investment Corp \(NASDAQ: GAIN\)](#)
- [Golub Capital BDC, Inc. \(NASDAQ: GBDC\)](#)
- [Hercules Technology Growth Capital \(NASDAQ: HTGC\)](#)
- [Horizon Technology Finance Corporation \(NASDAQ: HRZN\)](#)
- [KCAP Financial, Inc \(NASDAQ: KCAP\)](#)
- [Medley Capital Corp \(NYSE: MCC\)](#)
- [PennantPark Investment Corp \(NASDAQ: PNNT\)](#)
- [Prospect Capital Corp \(NASDAQ: PSEC\)](#)

New Mountain Finance Company (NMFC)

- \$1B NAV, pays 9.6% dividend quarterly.
- DRIP is available
- Is the dividend sustainable? Probably
 - Dividend has been steady \$1.36 per share since 2015
 - Dividends / Funds from operations = 0.86 - decreasing; this is good
 - Debt to Book Value = 893M / 1035M = 0.86 - high, but not ridiculous
 - Cash Flow Yield = 109M/1035M = 10.9% this is also good
- Externally managed, BUT insiders own 8.7% of the stock
 - Insiders are buying! This is excellent.
- Business exposure: Defensive sectors: Healthcare, Software firms - good
- Invested in 84 companies. All listed in the 10K Annual report - very transparent
 - Investments are rated 1-4 and reviewed frequently
 - Presently 100% of investments are rated 2 or better
 - Investment processes carefully controlled and fully disclosed

NMFC, cont'd

- Institutions own 39%: Wells Fargo owns 6.9M shares - a \$96M comittment
 - Morgan Stanley, UBS also major holders
- Short interest: 0.37% - very low, and that's good
- Two SBA licenses are enabled: \$300M in loan guarantees (1/3 of their NAV is government guaranteed)
- Assets increased 300% over 5 years - great!
- Revenue increased 218% over 5 years – very good
- Price to Book: 1.07 – very good
- Beta = 0.36 (very low correlation to S&P500) - good
- Shareholder friendly management incentive fee - fee is reduced for capital losses - very good
- Analyst ratings: Fidelity Neutral; Morningstar 3 stars
- Relative Strength Index: was 37 back in March, now 62.
- **Net result: Despite the stock being down 3.3% YoY, I am up 13.3% due to DRIP contributions**

Performance comparisons

[Full screen](#)[Indicators](#) [Comparison](#) [Date Range](#) [1D](#) [5D](#) [1M](#) [3M](#) [6M](#) [YTD](#) [1Y](#) [2Y](#) [5Y](#) [Max](#) [Interval](#) [1D](#) [Line](#) [Draw](#) [Settings](#) [Share](#) [Reset](#)

Conclusion

- Can be good for buy and hold investors - not for day-trading
 - MUST include DRIP for maximum benefit
 - MUST assess dividend sustainability
- Good time to invest in BDCs
 - Portfolio yields are increasing
 - Undervalued, RSI increasing
- Leverage limits recently increased
 - SBCAA legislation enables BDCs to increase their leverage from 150% to 200% of gross assets - good!
 - Banks and REITs have much higher leverage limits
 - But: S&P has put the BDC market on credit watch
- Watch RSI for points of entry
- Rising interest rates - slow and telegraphed well in advance
 - BDCs offer floating rate loans as protection
- Tariffs: The effect of new tariffs on BDC investments is TBD
 - But it can't be good
 - Second quarter filings in early August will show impact

Sources

- <https://www.kiplinger.com/slideshow/investing/T018-S001-10-high-yield-bdcs-that-could-get-a-lift-from-dc/index.html>
- Kindle Book: The Intelligent REIT Investor: How to Build Wealth with Real Estate Investment Trusts; 2015; by Stephanie Krewson-Kelly, R. Brad Thomas
- Seeking Alpha
 - BDC Buzz blog
- Fidelity
- Morningstar