Premium BDC panelists discuss BDCs during AICA Summer Summit.

Thursday, August 13, 2020

Scott Bluestein from HTGC, Barry Sloane from Newtek Business Services Corp, Dwayne Hyzak from Main Street Capital, and Bowen Diehl from Capital Southwest were panelists at the AICA Summer Summit held on August 13. The moderator of the panel was Bryce Rowe, of National Securities. Read the transcript from the discussion below to hear the insight from the panelists.

Bryce Rowe

Scott Bluestein

Barry Sloane

Dwayne Hyzak

Bowen Diehl

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Bryce Rowe: My name is Bryce Rowe, I am going to be moderating our panel today which is called the Premium BDC Panel. I first wanted to say good afternoon and thank you for the opportunity to moderate this panel. This panel is going to be recorded so those of you that can't join will be enjoying it after the fact. Our panel is composed of four very thoughtful and dynamic BDC CEO's, and the topic or theme of our panel today is why some BDCs trade better to NAV, what the common attributes are and what the unique traits of the managers are.

So in terms of valuations, the BDCs that are represented today are trading at or near premiums to NAV. I think it's in a different environment now that we're in this post-COVID world, but generally speaking these four BDCs have consistently traded at a premium to NAV. So if you

look at Capital Southwest trading around NAV right now, Hercules trading at a 15-17% premium, Main Street Capital at almost a 60% premium, and then Newtek, 25-26% premium today.

I think most observers would say that the common attribute of these four BDCs is that they're internally managed as opposed to most of the BDC industry that is externally managed. And obviously being internally managed generally provides the opportunity to capture operating leverage with growth and therefore better profitability. But I'm guessing that each of these CEO's will tell you that the investing strategy and performance is exponentially more important and a bigger driver or influencer of the valuation.

So in terms of format today, I plan to cover about 45 minutes of discussion between the panelists follow by some Q&A by me, and then we'll open it up to the audience in terms of Q&A. So on the panel today we have Bowen Diehl, who's CEO of Capital Southwest, Scott Bluestein from Hercules Capital, Dwayne Hyzak from Main Street Capital, and Barry Sloane from Newtek Business Services.

So what I'd like to do is ask each panelist to introduce themselves by speaking to what is unique about his respective BDC, and then maybe if there are some other thoughts in terms of common attributes, we'd love to hear that. So five to seven minutes of prepared commentary is what we expect from each of these guys, and I will go ahead and start it up with Scott from Hercules.

Scott Bluestein: Sure, thanks Bryce. Certainly appreciate the opportunity to speak to the panel and be joined by three very esteemed and established colleagues who are running some great firms. I think in terms of the question about why some BDCs trade at a premium, I think with respect to the bigger picture element, you hit the nail on the head. That there's certainly a common theme amongst the four BDCs that are represented on the this panel, and that is that in each case we are internally managed business-development companies. Which I'm not going to speak for the other gentlemen, but I can certainly tell you from our perspective, we believe and we've always believed it's simply a much more shareholder friendly operating model and we believe that that's the right way to run a public investment firm.

As you also pointed out, I think each of the four BDCs on this panel have some nuances to their business which just make them a little bit different from the vast majority of the other 55-60 publicly traded business-development companies that for the most part have historically traded either at net asset value or in many cases below net asset value. In the case of Hercules specific, Hercules is a little bit of a different animal in that although we consider ourselves to be a publicly traded investment firm in the broader direct lending business, we don't operate where the vast majority of BDCs operate. So we do not play in the lower middle market, middle market, upper middle market or traditional cashflow lending of the direct lending business. We participate in a much smaller more esoteric part of the market which we identify as either venture lending or growth stage lending.

The types of companies that we are lending to, for the vast majority of them are cashflow negative. We do not have traditional leverage metrics or attachment point metrics that you can look to. You can't do interest coverage or EBITDA coverage ratios against the vast majority of

our borrowers. Yet if you look at our business over a 15 year period, we've now committed about $10.5 billion to a little bit over 500 different companies and our annual loss rate on our positions is less than one basis point. So despite the fact that we've been able to find a niche in lending to cashflow negative companies, we believe that we've been able to do it in a way where our credit performance over an extended period of time has outperformed the majority of the other BDCs who are lending to what most investors consider to be a safer asset class in cashflow positive investments.

The other nuance of our business, which is a little bit different than the majority of other BDCs, is that not in every case but in the majority of cases we also get some equity upside in the majority of deals that we participate in. And that can be in the form of a direct share issuance, that can be in the form of a convertible instrument, that can be in the form of a right to invest which gives us the right to participate in a subsequent equity raise, or it can just be in the form of warrants. And when you look at our portfolio, we're very fortunate and very proud of the fact that we've been very involved in some truly great companies over the years.

A couple of very high profile ones that are in our portfolio now, we are the senior lender and an equity holder in Impossible Foods, which has obviously had a tremendous amount of publicity over the last few years. We're also the senior lender and equity holder in a public biotech company called Bridgebio, which was the largest biotech IPO of 2019. And so being associated and being partnered with some companies of that sort of spectrum, it gives our shareholders and stakeholders the ability to also participate in some of the upside that those companies are able to generate on a go-forward basis. And that's certainly one of the aspects that has led to our outperformance.

The last point that I'll make that I also think is a little important just has to do with the competitive aspects of the market. I think one of the things that you've seen with the majority of BDCs trading below net asset value is that over the last five to 10 years the competitive landscape has really tightened up. If there's a sponsor backed company that's looking for a proposal, you're going to have 10 to 12 lenders all bidding the same deal. Generally speaking in a lot of cases, that's going to be a race to the bottom in terms of structure and in terms of pricing.

Hercules has certainly seen some yield compression, particularly over the course of '18 and '19. Certainly more recently when you've had the Fed action that we had in March with the two big cuts. But we've not seen the same yield compression that the others have seen, and so our core yield today continues to be somewhere around 11.5-12.5%, our effective yield across our portfolio continues to be somewhere between 12-14%. And when you look at that yield profile with our credit profile and you compare that to the majority of other externally managed BDCs, it's pretty clear to see in our view why Hercules trades and has historically traded at a pretty substantial premium to net asset value.

Bryce Rowe: All right, thanks Scott. Barry, do you want to go next here?

Barry Sloane: Sure, I appreciate that and thank you everybody for attending. Newtek Business Services Corp. has been around for 22 years, 20 years as a public company, and we're coming up on our six year anniversary in November as a business-development corp. where we converted

from a regular C-corp to a BDC. The thrust of what Newtek Business Services Corp. does is it provides financial and business solutions to the small to medium sized middle market businesses all across the United States.

We're probably different than obviously every other BDC. We're closest to the internally managed BDCs as we think that the internally managed BDCs and Newtek actually have a significantly lower risk profile typically than the other externally managed BDCs. If you look at it really simply, if you take 1.5-2% plus incentive fees out of the equation, then you've got to pay a dividend. Our expenses are actually loaded in, so we've got to pay the dividend after the fact. So we're kind of bias to the fact that we think we should trade at significant discount to the market clearing yield on all BDCs. One of the reasons why we think we have traded at a premium historically is we've been able to go our dividend regularly every year over the course of six years between 5-10% a year. Last year we were able to go our dividend close to 10%, and the market clearly rewards a company like us for doing that.

We're fairly unique in that we own what we call portfolio companies, we own 100% of them. There's five silos underneath NEWT, the publicly traded BDC. We're a lender and that obviously gives us the primary qualification for being a BDC. We also own 100% of a payment processing company. We own 100% of a payroll health and benefits company. We own a 50 state license insurance agency. We own a cloud computing tech solution company. We own 100% of those entities, they're part of the Newtek brand, and we get referrals typically from alliance partners all over the United States, like Morgan Stanley, Raymond James, UBS, Navy Federal Credit Union, [inaudible] Trade Association. And these alliances drive customers to us, so we provide that solution to business owners.

Our flagship product is lending. We are the largest SBA7a lender in the United States as a non-bank, including banks for second largest. So we do more SBA7a loans individually than City Bank, Capital One Bank, and many other large banks that you know. As I said, we're number two. Everything we do is in 50 states. If you were to consolidate the employees at the portfolio companies, we have over 450 employees all across the United States that work on providing these business services and solutions. And the reason why we're able to generate high returns on equity which has driven our stock price and our growth in dividends, is because we're able to turn our capital.

The business solutions companies are not capital intensive, they have reoccurring revenue, it gives us really nice diversification, and in the lending space when you make a 7a loan, you're able to sell the government guaranteed piece off for anywhere between a 10-12% premium. So therefore we can make loans without aggressively growing the balance sheet, and a lot of the income we receive is gained on sale. But that gain on sale that we don't call renewable, it's reoccurring, we've been doing it for 17 years. We make loans, we sell them, and we do that quite frequently.

This year we are a fairly significant producer in PPP loans which many you are familiar with. There could be another program coming up, we hope that that'll be part of a stimulus plan. First of all, we hope the stimulus plan does happen, that'll be good for us and our customer base.

We've been a lender for over 20 years. Senior management team, five years, 10 years, 15 years. Peter Downs joined Newtek in 2003, he's our chief lending officer, he also sits on the board.

We have a great track record in small business lending, we think we understand the space really well. Our payment processing business and our tech solutions probably provide, in addition to the lending, about 90-95% of our dividend income, with insurance and payroll picking up the rear but we're optimistic about the overall suite of services. So I certainly appreciate the opportunity to present, we've very unique. We take advantage of the tax advantage structure of the BDC with operating. But most importantly, BDCs are supposed to provide finance to small businesses, and mentoring services, and that's what we do across all the different portfolios under the Newtek brand.

Bryce Rowe: Thanks for that, Barry. That's definitely a unique story for the BDC space. But like the common attribute that you just laid out there in terms of providing assistance to portfolio companies, I think that's lost a lot of times within the space, so appreciate that. Dwayne, do you want go next?

Dwayne Hyzak: Sure, thanks Bryce. And thanks to our host for allowing us to participate today, I greatly appreciate that opportunity. Similar to the comments from some of the other individuals before me, I would say that when I look at attributes that are common in BDCs that trade at a premium I really focus on two things. From an investment standpoint or an investment strategy standpoint, we think it's key to have a focus in an area that's very unique. There's a lot of BDCs, as I think Scott touched on earlier, that make investments that are very, very similar. So we think if you trade at a premium, you need to be doing something that's unique and different than all the other BDCs. As I'll touch on in a few minutes here, at Main Street we definitely think that we focus in a unique area. I think if you looked at all four of the panelists today and the companies that they lead, we also all share that same common attribute.

I think Scott touched on it a little bit earlier, I think when you look at the expense structure or the fee structure of the BDC. I won't necessarily say that the BDC has to be internally managed, but I do think that the fee structure has to be aligned with the type of investing activity that the BDC is performing. And that fee structure or expense structure has to be such that when you look at the gross returns that the BDC is generating from its portfolio, after you take those fees off, the return to the shareholder has to be significant enough to justify the risk. And I think that's the key common attribute across all BDCs, not just internally managed BDCs, but all BDCs that do trade at a premium, you would see that common attribute.

Looking specifically at Main Street to give a quick overview, we're a BDC headquartered in Houston, Texas. Today we manage just over 4 billion of assets or capital under management. The thing about our investment strategy that we think is materially different than all other BDCs, is that we focus on a part of the market that we define as the lower middle market. This part of the market from our standpoint has been and continues to be underserved from a capital standpoint, and we think that the underserved nature of the market allows us an opportunity for a very favorable return on investments for our investment activities in that space.

In addition to focusing on the lower middle market, we also take an approach where we're investing in both debt and equity in the lower middle market. These are self-sponsored transactions, so we're typically the only institutional investor in the capital structure. When you look at other BDCs, we think that is another thing that is very, very different, and we think it's one of the reasons that we have historically traded at a premium to net asset value. We think that should continue going forward when we look at the positive attributes of the investments we have in that lower middle market.

When you look at the benefits of that strategy, not only does it allow us to generate dividend income for our shareholders but we've also been able to consistently grow our net asset value per share largely through the performance of those equity investments, and we've also been able to make those investments and periodically realize significant gains off those investments. Which again, if you look at most participants in the space, we think you would see that that's a fairly significant difference in the return profiles that BDCs have historically generated off their investment portfolios.

The other part of our business that we think is very unique in the BDC space, and we say it's very unique because we're the only BDC that has this type of a business inside the BDC, is that we have an asset management business inside our BDC. Through that asset management business, today we manage just over a billion dollars of assets for third parties. When you look at that, we think it's a way that as an internally managed BDC we can realize benefits off the intangible value of our reputation, and our historical investment successes. And in doing so, generate what we think is a very, very favorable return for the shareholder without having to deploy capital or take investment risk, and generate a very attractive highly reoccurring fee stream that provides us additional income on our side to continue to grow and support our dividend income for our shareholders.

If you look at our history, what you would see is that as a result of the combination of that lower middle market focus and the asset management business over the last few years, we've been able to generate a consistently growing dividend income for our shareholders that's been covered by growing net investment income off the investment portfolio. And I would say as Scott touched on earlier, the ability to do that is largely not only driven by the investment strategy on the lower middle market side and the asset management business, but also the significant operating leverage that we've experienced over the last 10 plus years as we've grown our investment portfolio and benefited from a very efficient operating structure as an internally managed BDC.

Bryce Rowe: Thanks for that Dwayne. Bowen, maybe turn it over to you and then we'll get into some specific questions.

Bowen Diehl: Yeah, thanks Bryce. Bowen Diehl, CEO of Capital Southwest. Capital Southwest is probably the oldest BDC in many respects on this panel. We actually went public back in 1961, I wasn't even born yet but Capital Southwest for the first 50 years of its existence was an equity investor. Actually originally an SBIC and became a BDC in '88, but for the first 50 plus years was an equity investor, kind of a mini Berkshire Hathaway in some respects. They'd buy companies and hold them forever.

Moving into the 2000s, when you went from four or five BDCs to 50 plus BDCs public, the sector matured and became a sector where investors asked, why do we exist? And naturally most BDCs, virtually all of them are lenders or yield vehicles, and Capital Southwest was an equity investor paying no dividend to speak of. Had two of its companies it bought in the sixties grow to be half the portfolio and it was trading at a 50% discount to NAV, so really kind of a struggling situation.

I had been actually the co-head of the sponsor finance group at a BDC that's now part of Ares called American Capital. Doing lower middle market lending for 15-20 years and I saw the opportunity to join the CEO at the time of Capital Southwest, this little BDC I'd hardly even heard of down the street. A very real asset base but a very dysfunctional asset mix trading at 50% to book, and so I saw that as an opportunity. I joined in 2014 and we ended up announcing at the end of '14 that we were going to split the firm in half essentially and spin that industrial company that was half our business into separate company. The CEO would leave to run that industrial company and I'd become the CEO of Capital Southwest, and we would relaunch it as a middle market traditional lending BDC.

And so we launched that in January of '15. We have 22 employees today, 20 of the people were new since we launched formally, so complete rebuild of the team. Fortunately for me I had several very talented athletes over at American Capital that I recruited over to join me, including our CFO who had been the treasurer of American Capital for 15 years. So he and I both had seen American Capital grow, been a part of it and seen the firm do a lot of things well, and frankly a lot of things not well. And so we had the opportunity to actually to create a BDC largely from a blank sheet of paper.

Now we had an equity portfolio we had to go divest of and rotate out of but we were able to basically create a BDC the right way in our view. And so what we've done over the last five and a half years is we've created a BDC that now has $620 million dollars of assets, about $270 million market cap. Until the COVID pandemic, for the 18 months before that we were trading at about a 20-25% premium to NAV, paying a 10-11% dividend yield, and really just built a robust portfolio based on an investment strategy that we put in place back at the very beginning.

Our core business is the lower middle market. Our core asset class is first lien lending. And the idea there is it was going to be lower middle market which we like for a number of reasons. The leverage levels are typically much lower in the lower middle market. Covenants, documents, etcetera are very tight typically. And we can generate very attractive risk adjusted returns in the first lien security. And then we very oftentimes get to invest in the equity in the capital structure. Our business is about two thirds sponsored, so private equity firm controls the business, about a third of it is non-sponsored. In my experience, that's about the right mix. And we built a very traditional, keep it simple, lower middle market lending business. We laid out for our shareholders five and a half years ago a game plan and we followed it exactly to the tee like we said. We had to earn our credibility in the market.

Most people had never even heard of Capital Southwest back in 2015. No one covered the stock. We have seven analysts, such as all-stars like Bryce that cover our stock today. We're about 55% or so institutionally held and so we've got a fairly large institutional following. We've since

raised a baby bond issue and a couple of institutional bond issues, and so it's been a successful venture but it's all about what we do going forward and maintaining that credibility. So I appreciate being here today.

The only think I would add on the premium BDC question, and that is obviously we're all internally managed. We certainly believe the internally managed structure is the most closely aligned with shareholders. I don't make money unless our shareholders make money. I don't make money by doubling the asset base of the BDC to the extent growing assets helps us strategically in the market. Which there are things about that that do. We make money, so we have to drive, we have to build NAV per share, and build earnings for our shareholders.

And ultimately our shareholders care about both dividends and stock price. And so you can do things too aggressively at the BDC to drive dividends or earnings and you take a risk on perspective, such that the risk clearing yield that the market requires is high, so you take a step forward in dividends and you take one or two steps backwards in stock price. And so it's really an optimization equation in our view and that's where the fixed cost structure comes into play.

Internally managed BDCs are a very fixed-cost structure relatively speaking because it doesn't have a management fee that increases as assets increase. So the way we look at that is, if I can spend less on a percentage of assets on overhead, then either I'm going to drive higher ROE for our shareholders or similar ROE at less risk, and obviously it's a combination of both of those things. That's been kind of the way we've looked at it from the beginning, and team that we've assembled has done a lights out fantastic job in so many ways. So that's our story, Bryce.

Bryce Rowe: Bowen, thanks for that. Thanks for all the prepared remarks from the four of you all. I'm going to get into some questions now, and just for those that are participating here on the panel, there's a chat function on the Zoom screen that you can use to either send me a question that I can ask or you can also raise your hand and I believe we can unmute you to ask a question. So just in terms of logistics, love to get some participation here, so please use those functions if you'd like.

I'm going to ask Scott a question here. Obviously Scott, you've got the focus and the expertise on what you call the 'innovation economy' and that's a big unique for the space that contains mainly just traditional providers of private debt. So maybe you can speak to the origination, underwriting, and portfolio management infrastructure that's required to address that innovation economy and who do you compete against primarily?

Scott Bluestein: Sure, thanks Bryce. So a couple of different questions there. So first with respect to sort of how the business is built, I think you're spot on. It is a business model that is more personnel and time intensive given the types of companies that we are lending to and the profile of the companies that we are lending to. Right now we manage about $2.4 billion dollars in assets and we have 85 employees, 45 of which are focused on the investment side of our business. And if you compare and contrast that to the way most publicly traded externally managed lower middle market BDCs are built, we've got a lot more personnel per dollar of AUM than the majority of those companies given that it's a much more personnel intensive model.

Unlike cashflow lending where you can check in with the company on a monthly or quarterly basis and make sure that they're in covenant compliance, our business doesn't give us the luxury to do that. So our investment team is speaking with our CFOs, and our CEOs, and our chief medical officers, and our chief technology officers maybe not on a weekly basis but certainly on an every other week basis to make sure that we know what is going on and how those businesses are tracking. Because when you're burning capital, it is incredibly important that you get not too far behind the curve in terms of understanding what those businesses are doing or not doing.

From a competitive perspective, the competitive environment as I mentioned before, it's certainly not as intense as it is in middle market lending broadly speaking, but we do face a fair amount of competition. Our world is typically broken into two different buckets, the bank side of the market and the non-bank side of the market. On the bank side of venture lending or growth stage lending, Silicon Valley Bank has traditionally been the most dominant player. We compete with them from time to time on certain deals, but for the most part the profile and types of companies that they're going after are going to be a little bit different than what we're trying to do given that they're operating as a bank and we're operating as a public investment firm that doesn't have the same restrictions that they have given the oversight of the OCC or the Fed.

On the non-bank side, there are a couple of players that play in the venture lending or growth stage lending space, but none of them have chosen to build their business the way Hercules has chosen to build the business. And when I say that, I'm referring to the diversification strategy we have. Right now, 50% of our book is in our technology vertical, 50% of our book is in our life sciences vertical, and those two books of business behave differently. And the majority of competitors that we have in this space on the non-bank side really choose or select one of those two end markets to focus on. So there are a couple of players that focus exclusively on technology, there are a couple of players that focus on life sciences. We believe the best way to drive long-term shareholder value and platform value is by taking the market head on with a diversified model that allows us to focus on both of those verticals at the same time.

Bryce Rowe: Thanks for that, Scott. I'm going to mix it up a little bit for the panelists here. I've got a question coming from one of the listeners here and this can go to anybody, so whoever jumps in first. Is there anything that traditional private equity funds, private placement structures can do that BDCs cannot? If not, why own private placements at all? Who wants to take that?

Barry Sloane: I'll give you a quick simple answer. They can excessively lever and we have leverage limitations in terms of being able to get our returns on capital. I think that's the biggest difference.

Bryce Rowe: Go ahead, Dwayne.

Dwayne Hyzak: Bryce, I would say from an investment standpoint, I think as BDCs, we can do most everything that a private equity group can. As Barry said, there would be limitations on the leverage levels at which BDCs can be structured, but if you look at portfolio companies that we're investing in, we've got the same flexibility that a private equity firm or a private debt capital firm would have from an investment standpoint.

I think that when you look at the BDC model, I think there's a lot of clear advantages that come from our model, a lot of which are given to everyone in the industry through the permanent nature of our capital structure. So as a BDC, we're a permanent entity as opposed to private equity funds or most private debt funds that have a finite life. So when you look at the investment activities that we pursue, and I think a lot of other BDCs can and some do pursue, it's a different approach from an investment standpoint.

If you are making equity investments like we do at Main Street, we think it's a huge benefit for us when we go to market, and we tell our portfolio companies, "We can and will be your partner for as long as you want us to be. You're going to decide when Main Street's not your partner anymore." Not an arbitrary end-of-fund life structure issue that a traditional private equity fund or a private debt capital fund would have. We think that's a huge benefit and allows us a lot of flexibility and a lot of benefits when we go to market. It's a big part of the advantages or attributes of the BDC structure that we find really attractive and it fits our lower middle market investment strategy and approach very, very well.

Bryce Rowe: Two good answers. So we've got another question coming in from the audience and this is directed more to the traditional type lenders of Main Street and Capital Southwest. So maybe I'll ask Bowen first, how do you adapt your lending to take advantage of the current market dynamics ,especially with the pandemic top of mind? And then secondly, are you willing to increase second lien exposure in your portfolio if that's where the best risk/reward is?

Bowen Diehl: Yeah. For us, we prepared for the pandemic. The best things we did to prepare for the pandemic are things we did not expecting a pandemic ultimately. And that was maintaining lower leverage on the BDC, going into the pandemic with almost 60% of our capital in unsecured covenant light debt and having always been judicious every quarter to raise small amounts of equity capital through our ATM program every quarter over long periods of time at very low spreads to trade, and so we were always just looking at our business on a full cycle basis. And so when something unforeseen and horrible like the pandemic comes on board, we were better prepared than other BDCs, certain other BDCs in the space, none of which are on this phone call.

And so that was how we prepared ourselves for this unfortunate situation or anything else in the future. And so now we have the capital to invest, and so we've seen spreads initially widen by 200 plus basis points, now probably more 50 to 100 basis points. We're absolutely seeing less competition in the lower middle market in where we play. And so the reality is we have to underwrite the potential of a pandemic. I think if everybody was honest, nobody was even thinking about that six or nine months ago. And so a lot of business models that we see, you can't underwrite in that eventuality. And so the number of deals that we close goes down, but the return on the deals that we do do goes up, so it's been really nice. We've been able to originate a nice amount of deals since the pandemic began and a small handful of business models that we can underwrite. In fact, some of them have even thrived, fortunately or unfortunately, in the current environment.

So as far as going down to second lien, we always look at that possibility. So far the vast majority of the stuff that we've seen, the first lien loan is more efficiently financed through the

BDC, and ultimately creates a more optimal risk adjusted return than going down the balance sheet so far. But we've got a couple of second lien loans in the portfolio that are doing fine. Actually we've got one sub debt deal left in the portfolio that we did several years ago and that seems to be performing. But the vast majority of stuff we do and the risk adjusted return we see in the first lien.

One of the things that we like about first lien is that as much as my career I'd love everything to go perfectly, it never all does, and so as a first lien lender you have an easier and more straightforward path to a secondary form of repayment. And that includes owning the business if you need to own the business. We have people at Capital Southwest including myself who have owned business throughout our careers, been in a controlling equity type posture, and so know how to do that if that's the way we need to go. And so as a first lien lender, you have a much clearer path to the ownership suite, if you will, then you do as a second lien or sub debt. And that's a big differentiator in our opinion as far as the different securities in investing. So far as we've seen, the second lien yield in our market, our sub debt yield premium, it's hard to overcome the loss of that advantage and clear path to secondary form of payment.

Bryce Rowe: Dwayne, do you have any thoughts there as well?

Dwayne Hyzak: Yeah, I had a couple of points. I'd say I agree with almost everything that Bowen said. I think at Main Street we've maintained a very similar approach from the capital structure and liquidity standpoint on Main Street's balance sheet. We've always maintained a very conservative approach both to leverage and to liquidity. I think as we sit here today, I think we're the only BDC that has never requested the expanded leverage access that I think most if not all other BDCs have requested. And the reason we didn't do that as we look at our model specifically on the lower middle market side and the asset management side is that we're very comfortable that we can produce returns that are significant enough to reward the shareholder without taking that additional risk associated with the increased leverage.

So we've always had that view and it's one that we think has always served us well. But we've also always looked at opportunities like the time period we're in now, and never wanted to be in a position where because of our capital structure and liquidity position, we were not able to take advantage of opportunities in an environment like this that typically from our standpoint are the best opportunities that you're going to find. We as a team have been together now at the executive level for almost 20 years, and we look back over our history as both a public company and then for the decade prior to that as a private firm, and look back at cycles like this as being the best time to be deploying capital. If we look at a lot of the history of the BDC space, we would see other firms that have maximized 100% of the leverage that was available to them. And when we go into this type of a downturn, not only did their existing portfolio take a big step back, but they were not in position to take advantage of what would end up being some of the best investment opportunities that you could find over a cycle.

So we really look at this time as an opportunity where we expect to be active. We have been since the pandemic started and we're seeing what we think are very, very attractive investment opportunities. If you compare your current investment opportunities versus the last 12 to 14 months, we would favor these opportunities. Obviously you've got to be comfortable taking the

risks that there are, with some continued uncertainties associated with COVID. But we're confident as long as you're investing in really good companies, and more importantly investing with excellent management teams.

If you can do that and invest at a time period where most other people are choosing either not to invest or they can't invest, we're very confident that you're going to end up with a very good outcome. When we look at our permanent capital structure and our expectation that we could own these companies forever, if we can pick up some great companies with great management teams, we're very excited about that opportunity.

Bryce Rowe: Thanks for that Dwayne. It's interesting, going into COVID people were clearly focused on capital structure, but I think it's become that much more important to understand how important capital structure is and the opportunities that you give yourself in an environment like this.

All right, so I've got a question for Barry, and then I've got somebody that's raised his hand to ask a question. So I'm going to ask Barry this question first. Barry, you've got significant participation with the PPP loan program, curious what the return profile for NEWT in that program is? And then what's the average duration of one of those loans?

Barry Sloane: The PPP program for us, it's clearly a one-time event, maybe a two-time event, and then we move on. It was, I have to say, pretty incredible looking at the market in March with a lot uncertainty. We decided that we were going to stop making normal lending commitments and focus on the PPP program. The PPP program gave us the ability to make the loan and sell 100% of the loan off with our books. And when you played with the numbers, because you've got a certain amount of fees from the SBA for a small loan, a certain amount for a bigger loan, we averaged about 3.2 points for making a loan.

We made the loan, held it for two days, and then sold it to our investors, and the coupon on the loan was a 1% coupon. I know this is making everyone shudder right now. We live in the world of making single digit loans, so the return on capital is key to make the loan and get it off the books. We did 10,000 units in a two-month period of time, about $1.2 billion dollars worth of loans, and for the most part 98% of those were removed. It's a little complicated, we kept a little piece of them, but they're government guaranteed. So the investors were banks with zero-risk based capital, they were able to borrow at the Fed at 35 basis points, so they're happy. We're the servicer of those loans. Those loans will be predominantly forgiven.

If we have an opportunity to get a second bite of thee apple, if you think we're going to get a stimulus plan, the PPP program will be in it. Small business lending is probably the only bi-partisan thing in Washington these days. There is a young Bennet bill that is very supportive of another PPP program and additional SBA program called Restart, which is also 100% government guaranteed. So from my perspective, the ability to make a loan, make a profit effectively, sell it to a third party with no risk is an attractive business. That's why our return on equity is very, very high.

Over the course of 10 years, we've had a 25% return on equity per year for each of the 10 years. Over the last five years, about 188%. Last three, I think it was 90%. Last year 42%. The only way you can get that is by making loans, getting a profit, and moving them, and that's what we effectively do. In addition to growing our portfolio companies in payments, tech solutions, etcetera, which are not capital intensive, they're reoccurring fee businesses, those businesses pay tax, they do qualify under the 70% test because we control them and mentor them, so it works well. We have very few assets in that 30% bucket.

Bryce Rowe: Thanks for that. It sounds like with a 25%+ return on equity you should be trading at a steeper premium to NAV.

Barry Sloane: That's why we're here today.

Bryce Rowe: All right, so I've got somebody that wants to raise his hand. So I'm going to unmute Sam Ticker, I think. I'm going to try actually, let's see if I can do that. Sorry Sam, I can't do it.

Sam Ticker: I think I was just able to unmute myself.

Bryce Rowe: Go ahead, Sam.

Sam Ticker: Yeah, thanks. Hi everyone, Sam Ticker, GreenBlue Partners. I had a prepared question but Barry your comments about the PPP loan program, I had a follow-up to that first. So you mentioned that you were collecting around 3.2 points per dollar of par on the PPP loans you're originating.

Barry Sloane: Right.

Sam Ticker: On that topic, is this just the origination fee? Does it include any gain on sale? And to the extent that it does include gain on sale, how do investors or the ultimate buyers of this paper, how do they think about this pseudo pre-payment risk, if you will, for the forgiveness option that's built into the loan structure?

Barry Sloane: So there's approximately $525 billion of PPP loans that were made. Financial institutions can go to the Fed window at 35 basis points, it's zero-risk based capital so there's an arbitrage there. We sold those loans at par, so there was no gain on sale, we're strictly fee for service. For about 10 weeks, 200 people in this company worked seven days a week. It was just the most incredible crazy thing I've ever seen. We're positioned for that again, if they run another program it'll be a little different hits time. Businesses can actually get a second PPP loan if their revenues are down by 50%, but we like lending opportunities where you could make a loan, get a gain on sale, and move the risk out like a mortgage company.

Sam Ticker: Right. I appreciate that, thank you. And then my original question, which is on a related topic to the PPP which I direct to you and the broader group considering all of your somewhat differentiated approaches to the middle market, lower middle market, and in Newtek's case really to some extent the small business universe. When you think about your approach to

book value and marked to market, especially with the uncertain outlook today, is any continued or renewed stimulus or fresh PPP baked into your assumption set for these fair values? How do you think about the future with respect to your balance sheet today considering that fair values are at least somewhat forward looking? Thanks.

Barry Sloane: I don't want to hog the flor, I'm going to answer this quickly. Our $400 million SBA7a portfolio of uninsured loan participations are all valued assuming, and this is extremely conservative, a 30% cumulative default going forward. That means one in three. We don't think, that's how we have it marked, with a 40% severity which is our historical severity. That's where it's marked in our books, and as a six percent floating rate coupon at 2.75 above prime. So our borrowers are able to get PPP money.

Also, for borrowing through the SBA program, the government as part of the CARES Act, paid six months worth of principal and interest payments for the borrower. So my portfolio's currently 99% current. We always worry about what's going to happen down the road, if there's a new stimulus program there's still money that's available and those borrowers will get those funds. The good news, and I think my colleagues will be able to answer this, we have a science problem with the virus but we also have a government shutdown problem which is limiting what businesses can and can't do. And when that goes away, these businesses are going to be able to-- I'm not saying it's like a faucet, but they'll be able to get back up. And a lot of these business, entrepreneurs, operators, all our loans are personally guaranteed, they ramp down, they'll have to ramp back up. We presume we're going to lose a decent amount of businesses, but our loan portfolio is marked that way, we think, pretty conservatively.

Bryce Rowe: Thanks for that Barry. Bowen, Dwayne or Scott, do you guys have any thoughts on the PPP program? If a second stimulus program comes in, maybe talk a little bit about what's in your portfolio now in terms of participation with those government programs.

Bowen Diehl: Yeah, sure. To your specific question, no, our valuation process does not take into account a future influx of PPP money across our portfolio. That wouldn't really be a component of the valuations we would use, not to mention you couldn't assume that. Across our portfolio the vast majority of the companies are in the lower middle market, so you can imagine many of them do hit the small business criteria for the PPP funding. Indeed 90+ percent of our pipeline are small business. In fact, we just announced a green light letter with the SBA a week or so ago, and so if we get approval with a license, we'll be launching SBIC. Which is just more of what we do in the lower middle market and it'll expand our capital base.

Most of our companies fall squarely within the criteria, fortunately for us, we look across our portfolio we have very few companies that needed any kind of interest relief. Certainly we can see a slowdown in the economy in the portfolio. We've always been kind of adverse to taking on a whole lot of cyclical risk, certainly not levering companies up more than what they can handle in a severe kind of great recession type construct. So those capital structures now are showing the value in that approach, and so our companies are generally pretty healthy, certainly from a first lien lender looking down the capital structure. But if there's another stimulus plan there's a whole host other of them that would be eligible, but we're not relying on that for valuation purposes or frankly for survival purposes either.

Bryce Rowe: All right, thanks Bowen. Scott, I don't want to leave you out here so I've got a question from the chat. Question is this, middle market lenders speak about private equity sponsors playing a role in their lending agreements and expectations, particularly when a loan is struggling. So as a venture debt provider, do you have an active dialogue with venture lenders when a venture debt investment isn't meeting their goals? And then do venture lenders have the ability and structure to put in additional capital to fix a situation that may not be performing up to par?

Scott Bluestein: Sure, so a couple great questions there. So when you think about our business and you compare it to traditional middle market lending where you have a private equity sponsor that completes a buyout and it's financed by any of the number of middle market lenders that are in the market, generally speaking in most every case there's going to be one private equity sponsor who controls the majority of the cap table. The key difference in our business is that most of our cap tables are made up of three to five different institutional investors.

So in middle market lending you have one private equity sponsor that owns and controls the cap table. In venture lending or growth stage lending, those companies typically have three, four, or five different institutional venture capital investors in the cap table. Any one of which that can finance and fund that company by themselves on a go-forward basis. So we actually view it as a more attractive place to be in middle market lending. If a private equity sponsor decides they're not going to support the company, the lender is forced into a situation where it needs to take action. In our world, if one venture capital investor decides that they're not going to support the company, you have two, three, or in some cases, four other capital investors who are more than capable of stepping up and financing that business.

On the second part of the question, we have seen tremendous capital inflows from VCs into growth stage companies since the beginning of the pandemic. If you look in our portfolio specifically, and we've disclosed this on our two most recent earnings calls, we've had over 45 portfolio companies raise in excess of $3 billion in equity capital since the pandemic started in the United States, and that's just a tremendous amount of liquidity and support for our borrowers. We maintain very active discussions and relationships with the vast majority of the VCs that we do busines with. Our team is in constant communication with them, just as we're in constant communication with the portfolio companies. And if there are issues, we absolutely do reach out to the VCs and we certainly stress the importance of them needing to provide additional liquidity if that's the situation that we're in.

Bryce Rowe: Great, thank you. So we've got about five or six minutes left and I wanted to ask about an issue that's kin of pertinent, or is percolating here in the BDC space now and really could have an impact on BDC valuations. I think you all would agree that having a premium to NAV valuation provides a huge benefit, whether it be the ability to raise capital and the ability to optimize your capital structure over time.

So I'll ask Dwayne this, and everybody else is welcome to weigh in after Dwayne answers. So Dwayne, Main Street has really long been involved in shaping or influencing how the BDC industry is viewed in D.C. Given the recent movement on the acquired fund fees and expenses

issue, what's your view of the proposed change? And how significant of an impact do you believe it could on the BDC industry both long and short-term?

Dwayne Hyzak: Thanks Bryce, as you said, we've always tried to maintain a very active role in the industry's initiatives in D.C. The BDC industry has a lot of positives, but it's also an industry that's very, very regulated. So being active in D.C. is a big part of what the industry has had to do historically. On this AFFE topic that you referenced, I'd say that we and others across the industry have been actively engaged since 2014, which is the year in which the indices, primarily the Russell and S&P decided that given the issues associated with AFFE, that they were going to exclude BDCs from their indices.

That obviously caused a significant decrease in the institutional investor interest in the industry, so that was from our standpoint and others in the industry, viewed to be a very big negative. When we look at the activities that have happened here over the last week or so, we view them as very big positives. We finally have activity from the SEC that looks like it is going to make a significant positive change for the industry. We know that there are some participants in the industry that will want additional changes and we would agree with them that there's additional changes that could be beneficial. But when we look at the changes that have been proposed which would kind of fix, at least partially, this AFFE issue, we view it as a big negative and a very significant step in the right direction.

Short-term, it likely won't have as big an impact as the industry hopes. The impact could be long-term because you'll still have an issue with Russell, and S&P, and other indices, they'll likely have to take additional steps, which would be to change their position on excluding BDCs from those indices. The SEC's change can't or won't fix that. But even if you don't have the indices come in, we think that it should be a net positive for other institutional investors that are negatively impacted by AFFE and it could cause those institutional investors to take an increased interest in this space.

We think that increased interest would be positive across the board. We think it would be a very big positive for the retail investors. One of the things that the BDC industry has not had historically as much as other industries is broad coverage from people like Bryce. Obviously we think Bryce and others that track the industry do a great job, but I'd say the industry is probably underrepresented from an analyst or research coverage standpoint, and we think that is partly due to the fact that the institutional investors haven't had the same interest or investment activity in this space.

So we think short-term it'll be a positive, we just can't really determine how big of a positive long-term. If we can get the SEC change to get approved, which again, I think we feel as optimistic today as we've ever felt about that change being approved. And then we can further as an industry get the Russell, S&P and other indices to include the BDCs in their indexes again. We think long-term that could be a very, very significant positive for the space when you look at the amount of passive activity that exists in the broader market, and the demand that could be created by the reintroduction of BDCs into those indices long-term.

Bryce Rowe: Anybody else have anything to add there?

Barry Sloane: I guess the only thing I'd like to add is to take a look at the market clearing yield of BDCs versus REITs, you've got a huge gap. It's like off the charts. And if you think about just the raw loan backed by commercial real estate versus a loan backed by cashflow, yeah, there should be some spread there, but the spread shouldn't be as wide as it currently is. So we focus a lot on risk and reward, and a lot of equity investors, they don't, they just look at cashflow. And sometimes companies wind up in trouble because they wind up with too much operating or financial leverage.

I think that discriminating investors should take a look at what kind of yields you're getting, in the case of a BDC or a REIT or some other fund, and BDCs without a lot of institutional participation, there's this huge pool of money out there that we don't get to see. So I think there's going to be a big difference, we're real optimistic. I certainly appreciate Dwayne's comments, and Main Street and the other participant's work in getting this approved with the SBA, we've got our fingers crossed. And I think if this goes through, it's going to be a very big deal for the industry.

Bryce Rowe: I tend to agree. I think there's a tailwind that's associated with this AFFE and especially with most BDCs trading below NAV. I think there's significant opportunity for some upside in stock prices, so certainly look forward to seeing what that impact ultimately is.

All right, I think we're finished in terms of time here. I did want to end by thanking Barry Sloane from Newtek for being a sponsor of this AICA event. I think it's been a successful event and one that the folks at AICA have pulled off well in this remote time that we're living through. I've also been asked to remind everyone that there's a networking room, and the link to join the networking room is on the main conference page. So now that we're finished here, please feel free to join that networking room. Lastly, just wanted to thank our panelists, Scott, Barry, Dwayne, and Bowen, it's been a nice active panel to moderate, and I certainly appreciate the opportunity to do it. So with that, I think we call it quits and everybody have a nice afternoon.

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