Panelists speak during AICA Summer Summit about BDCs from a service provider perspective.

Thursday, August 13, 2020

Michael Shekel from Cherry Bekaert, Kelly Thompson from Direct Lending Deals, and Nicole Eisenberger from Ernst & Young were panelists at the AICA Summer Summit held on August 13. The moderator of the panel was Mark O'Brien, of Advantage Data. Read the transcript from the discussion below to hear the insight from the panelists.




Mark O'Brien Michael Shekel Kelly Thompson Nicole Eisenberger

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Mark O'Brien: For those of you listening in, thank you for taking the time to join us this afternoon. Each of us have sat in for portions of the conference thus far and found it to be very informative. My name is Mark O'Brien and I'm honored to be the moderator for such an esteemed panel of individuals. For reference again, just to be clear, the topic today, BDCs from a service provider perspective.

So each of us are service providers in this industry to one extent or another. We'll take some time to walk through who we are, what we do, and as I've said many times during our prep session, the pain that we address. But first of all, let me introduce each panellist and ask that in turn each of you talk a little bit about your background and the role you play, and then we'll get into a little bit more into the role we play in the industry.

So the participants are Kelly Thompson, founder and editor Direct Lending Deals. Nicole Eisenberger, partner, Ernst & Young. And Michael Shekel, director of valuation advisory services Cherry Bekaert. And again, I'm Mark O'Brien, head of sales and marketing at Advantage Data. So Kelly, why don't we start with you. Perhaps you could introduce yourself a little further, give some background. And then we'll go to Nicole, on to Michael, and then I'll follow up it a brief background as well.

Kelly Thompson: Sure. Hi, my name is Kelly Thompson. I'm based in Chicago and I'm the founder and editor of Direct Lending Deals. We cover sponsored leveraged lending that is clubbed up or considered private credit, which means it's not syndicated and it's not traded. The bulk of our coverage is for lower middle market deals, but we also cover large jumbo unitranche loans.

Most recently we did a write-up on the billion dollar rescue deal for Bombardier, which was a couple of weeks ago. I launched last September, and so far, so good. Before that I was at a start-up for Leeds Equity. It was a capital markets publication and we successfully sold it to Fitch Ratings about 18 months into it. Before that I was with S&P LCD for about 15 years, where I covered a little bit of everything, but mostly middle market lending. So I have about 20 years capital markets experience.

Mark O'Brien: Great background, thank you. Nicole, why don't we throw it to you?

Nicole Eisenberger: Sure. Good afternoon everybody, it's really great to be here today. I'm Nicole Eisenberger, I'm an insurance partner in Ernst & Young's financial services group. I started out in real estate, made a move over to financial services, which has a little bit of real estate too sometimes but I mostly spend my time right now focused on BDCs, private equity funds, and hedge funds. And that's me in a nutshell, I'm a lot shorter, I've spent my whole career in one place.

Mark O'Brien: Thank you Nicole. Michael, why don't we turn it to you?

Michael Shekel: Thank you Mark, and nice to meet everybody. I'm currently in between Kelly and Nicole, I spent time in a couple of stations. Currently director, as Mark mentioned, with Cherry Bekaert, valuations services. One of our key areas is focusing on quarterly valuations of BDCs. Just like Nicole, I also have a significant background in real estate. But yeah, definitely enjoying conducting valuations across the board, including BDCs, and it always keeps us challenged.

Mark O'Brien: Indeed. Thank you Michael. Once again, I'm Mark O'Brien, head of sales and marketing for Advantage Data. I'm also the president of an affiliate of Advantage Data called Best Credit, so I've spent the majority of my illustrious career in the provision of vendor to the financial services industry. I spent t e majority of my career with Interactive Data, now ICE Data

Services. I had a great career there, a lot of fun, great people. But I wanted to do something a little bit more entrepreneurial.

And so while Advantage Data is a 20+ year old firm, we still very much are a young company in terms of who we are and what we're trying to accomplish. I'll get into that in a little more detail when we get into the next agenda item. So while I launch into that, for the benefit of the listeners, we put together five or six agenda items, topics that we thought would be of interest to you, the audience. But by all means, we want this to be a dialogue. We do not want to simply pontificate, we welcome the opportunity to get input, to get feedback, to address questions. So please don't hesitate at any time to send across a question. We have access to the chat function, we'll see the question and one of us will jump on it. So again, can't emphasize enough, let's make this a dialogue. While we have already had some fun prepping for this and we've enjoyed interacting with each other, it would be that much better if we can also get some feedback from the audience.

So with that, agenda item one as I touched on a few moments ago, we thought it would be interesting to give a little more background as to who we are, what we do, the companies we work for, the markets we serve. And as I've said a couple times, specifically the pain that we saw for our clients. And so why don't we just go around the horn again and perhaps we can provide a little bit more detail as to the clients we serve, the function we provide, and the problems we solve. So I guess Kelly, if you don't mind, I'll just throw it back to you to start.

Kelly Thompson: Sure. So Direct Lending Deals is a publication. It's different from the others in that all of the deals that we cover, and the fundraising, and the people and all that stuff, it's all lower middle market/club deals that aren't syndicated. These loans, in an opaque marketplace, it's difficult to get information on them, it's difficult to get pricing on them, and we're the only publication that is doing that. And how do we do that? I've been around a long time and I know a lot of people, and so I try to extract as much information just from contacts that I have in the market. I cover trends and we also write about fundraising, and BDCs definitely fall into my world because they for the most part invest in middle market companies. Most of which are traditional sized to lower middle market, so that's definitely in my wheelhouse.

What we do at DLD is basically just try to bring more terms and more information to light on this market. Because it is opaque, it doesn't trade, the deals are small, lenders are very clubby with who they talk to and who they do deals with. So I try to bring as much information on the direct lending market as possible for our subscribers.

Mark O'Brien: Yeah, there's no two ways about it, there's a lot of demand for what you do. I think you really hit the sweet spot, Kelly. One question if I may ask, be selfish since we're chatting, how do you define middle market and lower middle market? I have my definition, I'm just curious to know if maybe you can share with the audience your view as to what the distinction is between say broadly syndicated and middle market.

Kelly Thompson: That's a great question and it depends on who you ask. But generally I would say traditional middle market is companies that have 50 million EBITDA or less, that's sort of your broad definition. And then if you want to drill down into that to lower middle market, those would be companies that generate, a lot of the times it's 3 million to 15 million of EBITDA. But also a lot of people would say anything under 25 million of EBITDA is lower middle market. So there's segmentation within the middle market and that's sort of where the broad guidelines are.

Michael Shekel: If I may, I would definitely agree it's depending on who you ask. Some publications, and obviously from a valuations perspective, we rely heavily on market data. Whether from you, Mark, Advantage Data or from Kelly and other, and LCD. Some publications actually quote in revenues in how they define, not necessarily EBITDA.

Kelly Thompson: Or enterprise value is another way.

Michael Shekel: Exactly. So it really depends who you ask. And then when you do evaluation and analysis, it's really important to specify, "Our conclusion is based on data that really focused on middle market, lower market, based on EBITDA, revenue," so you really get a high degree of comparability.

Kelly Thompson: Yeah. I would just add there's basically three tiers. There's lower middle market, there's traditional middle market, and then upper middle market which would be companies that are 50-65 million of EBITDA. And you're probably thinking, "Why is there so much differentiation? Who cares, they all sound like they're middle market?" But the terms that a company with 60 million of EBITDA can get done are vastly different from a company that has 20 million of EBITDA. It's just a completely different ballgame.

You'll see across BDCs, there are some BDCs that play more upmarket, and then there are BDCs that play more downmarket toward the lower middle market end. It's important to understand where their sweet spot is because that will affect their yields, it'll affect their non-accruals. They're all separate boxes within middle market.

Michael Shekel: Yeah. Mark, maybe you can explain as well but it really comes down to the market data. Where can they extract the most data? Is it from a segment that is really 50 million in EBITDA or wealth, or to really to kind of expand the population, 200 million of revenue? It's really driven by, how can you extract the best data for the market participants to utilize it?

Mark O'Brien: Yeah, and again the challenge is this data isn't always available. From Advantage Data's perspective, and Michael you know this, and Kelly, you've used our application as well. We distinguish it as a function of debt outstanding, so 500 million or less in debt outstanding we deem to be middle market. We would love to be able to measure it as a function of EBITDA but that data isn't always available to us. That's not necessarily available in the market.

Kelly Thompson: It's rarely available, especially among private companies.

Mark O'Brien: Yeah, so clearly as a service provider, I find these conversations interesting because there's without question a need for this information and it's not currently being aggregated beyond some of the things we do and some of the thigs you do. So I suspect we all agree, this market, the middle market and BDCs will continue to grow, they'll continue to be more focused. And so there'll be opportunity for service providers to fill in these gaps. Well thank you Kelly, Nicole let me throw it to you.

Nicole Eisenberger: Thank you. From my perspective, from the audit perspective, assurance perspective, really where we help our clients and their particular pain points is obviously in their financial reporting and making sure they don't run a muck of the rules and their regulators. And so we're kind of in that role primarily, we also provide advice and assist them with giving them tips on how to document that information and so on. So that's really where we're helping them, but their biggest pain point besides getting accurate financial reporting, the largest piece of that, and we're going to touch upon this, I think most of today is going to be on valuation.

Because a lot of the other nuts and bolts of financial reporting are rarely as judgemental. And so the valuations, I think, is the biggest pain point. So where we come in as the auditors, we have to insure that they're applying the rules as required by generally accepted accounting principals. Clearly reporting fair-value, so how did they arrive at fair-value? What is the definition of fair-value? Just for the audience, it's defined under GAAP, generally accepted accounting principals, as the price that would be received to sell and asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date.

If you just listen to that definition, in today's market, what's orderly, what's transparent, what is the market? And so it's always their pain point, but I think we're going to talk today about right now it's more painful, and we help our clients with that.

Mark O'Brien: For the benefit of the listeners, who would you say are the primary regulators, Nicole? I'm not even sure I could answer. Certainly the SEC, but who else would you say is a regulator of BDCs?

Nicole Eisenberger: I honestly would say the SEC primarily. We have regulators, so the auditors now are regulated. And so by virtue, we're making sure we're doing everything right because our oversight, they're going to come in and look at whether I've done everything right, so I need to make sure my clients have done everything right. So it has that spiraling effect but the SEC primarily I would say is the largest body that regulates the BDC space. Being 40 Act registered funds filing under the 3334 Act, they just have problems abound.

Mark O'Brien: Got it. Which makes sense because in my simple perspective the SEC is responsible for protecting the individual investor and many BDCs are invested in by individuals. Certainly institutions as well but a lot of individuals so it makes sense. Thank you, Nicole. Michael, why don't I throw it to you and ask you to do the same. If you could give us a little background on your role and how you help clients out.

Michael Shekel: So from the valuation perspective, as Kelly and Nicole mentioned, we're not dealing with the stock of Apple or Microsoft, information and trading is available on a second by second basis. I think one of the key pains from the client perspective is, first of all from their perspective is how do you bridge direct pricing that they can get from a third party into a true market conclusion of their investments? There's plenty of third-party direct pricing that can provide you a price, but then we come in and say, "Are we sure this is a true market indication? Do we have enough [inaudible] of disparity to overcome?" and so forth.

And then the other significant thing is the lagging of financial information. When we do quarterly evolutions, let's say as of June 30th, we're dealing with historical financials as of a quarter ago. Because financials are not readily available on a daily, monthly, even quarterly basis as you would want to, and so how do we get to a valuation conclusion as of a specific date? Using historical data and also making sure that we're capturing financial projections that are up to date, management guidance. And this is very true in today's market under COVID-19, how do we get comfortable with the new normal? So all these points of view from the client perspective, we want to try to capture and make the pain a little less if possible as we conduct our quarterly valuations.

Mark O'Brien: Got it. For the benefit of our listeners, Michael, unless I'm mistaken, quite often you will contract with the BDCs to do that valuation for them on a quarterly basis. They will provide you with income statements, balance sheet, information and so forth to aid you in that process. Again, unless I'm mistaken, quite often its built into what's called the prospectus, the BDC prospectus. That you or one of your competitors will be responsible or undertaking that responsibility. Is that accurate?

Michael Shekel: Yeah, absolutely. So we're engaged directly by the BDCs to assist them in conducting the fair-value analysis of their various positions, typically a debt position but also equity and real estate related within their portfolio companies. So a large BDC would have 100 portfolio companies, a smaller BDC could have five to 10, and so it really varies. And so as part of our process, we deal directly with the BDC deal team to make sure that we have the right data as it pertains to the specific underlying operating company and business, which goes back to the purpose of the BDC. They're trying to help the middle market companies succeed in this particular environment and produce significant yield to this investors, and so it's a whole process that we are trying to assist the client in. But yeah, you're right, we're engaged by the BDCs on a quarterly basis to provide fair-value conclusions that ultimately are being audited by the respective auditors.

Nicole Eisenberger: Actually, that's about where I was going to jump in. If they're lucky they get to work with folks like us as well. Not just working with BDCs and the investors, but then us as oversight and we come in as the auditors. We deal very often in our process in working with and talking to those valuation experts, whether internal or external, to make sure we understand how they arrived at those values, the inputs of those values, and that's a large part of what we do in our process of assuring that it's in accordance with the rules.

Mark O'Brien: Got it. You audit and validate that process, if you will, that Michael undertakes.

Nicole Eisenberger: Correct.

Mark O'Brien: And that valuation ultimately, for the benefit again for the audience, is that the valuation that ultimately is submitted to the SEC on a quarterly basis?

Nicole Eisenberger: They didn't actually get the valuation. Well, the concluded value ultimately would be what would be reported in the financial statements, but the actual valuation itself is retained by management and it's important that they have that. We'll probably touch upon it later on during this session, but where the regulator might come in and want to review a client and how they've arrived at a certain value, it's rare that they're going to challenge the judgement that management, the BDC has arrived at.

It's more often that they're looking what did you do in order to develop those valuations? How did you document and support those valuations? A level of rigor was around that. That's really what they're looking for. Did you take everything into consideration? How have you assessed it? What methodologies did you use and were you consistent? They're not int he position of saying, "I think this value's better than that value." There's a lot of art with the science but that information, and what Michael and his firm does and others, they retain that to support the values that they're going to report to the public.

Michael Shekel: Right, and if I can add, we're engaged by the BDCs, but at the same time when we're dealing with [inaudible], obviously there's lmisted issues. But at the end of the day, if we're dealing with a complex valuation, yes, we want to have a direct conversation with the BDCs, our client. But at the same time you want to have a meeting of the minds with the auditors to make sure that everybody's on the same page and we are serving the mutual leaders of the financials to provide them with a correct, reasonable fair-value indication. And so we're working closely with the auditors and with management, the client, to make sure that the judgement we apply, and there's certainly a level judgement, is reasonable given certain inputs and assumptions that can be tested. That's ultimately the goal.

Mark O'Brien: Yeah, and we'll get into that in a couple minutes. Thank you, so just a very brief summary of Advantage Data. Again, 25-year-old firm, Boston based, as if you hadn't been able to recognize my accent. And we are focused on providing a workstation to buy side and sell side, probably more heavily weighted to the sell side, specifically front office. So traditional use cases for the Advantage Data workstation are debt capital markets; restructuring, leverage finance, distressed debt. These are sort of our typical use cases.

And by the way we provide pricing, we provide research, we provide some reference data. For those of who aren't familiar with data necessarily, reference data is effectively everything that's not pricing, so coupon, maturity, call schedules, book schedules and so forth. It's a comprehensive platform that allows you to do research on a particular instrument and ultimately determine what action you want to take. You can do some searches and so forth. So again, from a data perspective, high-yield, investment grade, we are very heavily involved in the provision of loan data, so broadly syndicated and middle market loan data. And relevant to this conversation, business-development company data.

So I'm sure this panel knows, I'm sure our audience knows that on a quarterly basis the BDCs are obligated to the submit to the SEC, a filing summarizing your holdings and valuations we had just touched on. What's interesting is that each of the BDCs will provide it in large measure in their own format. And so there's a lot of frustration across the industry because if you want to take a consistent view of this content, you have to basically normalize the data. So that's what we do.

We take the SEC data, the data gets filed, it's public information. We database it, we normalize it, we put some analytics around it, and we provide it as a tool to our clients to allow them to look across BDCs, to compare BDCs, to look within BDCs. And so that's the service we provide in a nutshell, the provision of the SEC data allowing clients both current data as well as historic data to do research on the BDC holdings.

Michael Shekel: Mark, maybe just a quick follow up. Given your experience, have you seen any more streamlined information coming from the BDCs over the years? Or just the same process?

Mark O'Brien: It's pretty much the same process from what I can see. Which again, means that it's inconsistent across the BDCs. So no, I haven't really seen much of an evolution. I would say the quality of the content is certainly getting better but the format, the input I see it as being very much the same. Although I'd be curious to see if anybody on the panel has a different perspective on that.

Kelly Thompson: I don't think they've changed that much. I think some BDCs have decided that maybe they want to disclose a little bit more information than they were before that they don't have to disclose. But because the main players have been doing a better job of reporting what's the average leverage of their portfolio, well you don't have to report that, but there are a few BDCs that do that. The more transparent you are, the more trustworthy you look.

And I think it's slowly evolving as to the extra information that they want to provide, it's being done, and some BDCs are better than others with that. But it really is scatter shot. And some BDCs don't even break out what's first lien, second lien, they'll just say it's a senior secured investment and you don't know whether it's first lien or second lien. Which obviously there's a big difference there.

Yeah, they're all over the map, and I think that's one of the great values that BDC databases like Advantage Data have. Is that they take all of these non-standard filings that BDCs do and they put it into a standard format that you can easily compare across. It's just a huge timesaver. So while it's publicly available, they do all that work so you can just plug in whatever it is you want to look for and 'BAM' it's there. Rather than try to sift through every 10Q yourself with 10 different formats, and not everybody provides the same information. It's just crazy. And I guess in a nutshell it's a long way of saying I haven't seen filings change that much in the past 10 years since I've been covering them.

Mark O'Brien: Great. And from a use case perspective we've got a range of clients, BDCs themselves, investors in BDCs, and a lot of the analysts. So we endeavor to make the data available within a few hours after it's published on the SEC website. Some of our participants are financial analysts, so think about the BDC analysts in your organization, that person wants to be able to get on a conference call and ask probing questions. So quite often they'll use our content to do that research, and so they're all over us to get to them so they can run it through their systems and be prepared on those calls. So there you go.

Maybe we should just push on to agenda item two, and then we'll get into some of the valuation stuff we wanted to talk about. But I thought it would be interesting, again for the benefit of the listeners, to talk briefly about the pros and cons of BDCs compared to other funds that invest in the middle market. Kelly, if you don't mind maybe I'll throw it to you, you had some interesting feedback on this. So what are the pros and cons of BDCs?

Kelly Thompson: So BDCs basically invest in middle market companies. Middle market CLOs do the same thing. Private credit funds, direct lending funds specifically do the same thing. So these are three different types of vehicles, they all pretty much invest in the same middle market loan or equity or mezzanine or whatever it is they specialize in. There's just different constraints to each different vehicle.

For BDCs, a couple of advantages that they have over some of the others is that they're very liquid. So if you're a fund manager or an asset allocator and you don't like the way the manager is running the fund or whatever, if it's public you just trade out of it. Your money's not locked up for five or seven years like it would be in a CLO or a direct lending fund. Also, just from a capital structure standpoint, BDCs are a lot less leveraged than middle market CLOs. Those can be up to five to seven times leveraged, whereas BDCs are probably around one to one and a half now. I would say they can go to up to two now, which is new. But comparatively, that's not much, especially when you look at other funds like hedge funds and other different types of investments out there. They're not highly leveraged funds.

Obviously you have dividends. BDCs have to mark to market. CLOs, I think, do sometimes but they don't have to. I think they provide that information to their investors but they don't necessarily have to, whereas BDCs do. And I would say probably the biggest advantage of investing in middle market loans through a BDC is they have to disclose their schedule of investments every quarter. So if you want to be a credit nerd and dive down into what's in their portfolios, you can do that because everything is listed there.

The name of the company, the type of investment, what is the interest rate that they're paying on it, what is it valued? Is it valued at par, is it valued at a distress level? Does this credit look like it's in trouble? How many credits are in trouble in their portfolio? You can see all of that, whereas you might not get the same level of disclosure in a private credit fund, direct lending fund, or different type of vehicle. So I would say, for me as a reporter covering that stuff, to me that's the biggest advantage of looking at BDCs.

Some of the cons, management fees are higher on BDCs. I would say today they're around 1-1.5% depending on if they've gone public yet or not. Whereas if you're looking to invest in a middle market CLO, I think the management fees there are around 50 basis points, they're much lower. Yeah, I would say in a nutshell those are really the pros and cons of putting your money in a BDC versus a direct lending fund or a middle market CLO.

Mark O'Brien: That's helpful. Nicole, Michael, anything you want to add to that?

Nicole Eisenberger: I would add, in addition to what you can see, it's also the concentration risk. So because that was just one of the things that you didn't mention, but if you look at the schedule of investments you can also see are they heavily weighted in one industry versus another? When you're in oil and gas you're like, "Okay, I don't want to touch that BDC," or the like. So it's that kind of transparency that's also available that you can glean from their schedule of investments.

But for the most part, they also struggle from some of the same things. Because they dabble in middle market, this is their area, valuations of those investments are something that they struggle with in putting out there to the public. So I've been cautious. Wen you're looking at those valuations, a lot of a rigor around those, but these are still very opaque investments and there's still risk associated with that.

Mark O'Brien: Yeah, great feedback. Michael, anything you want to add to that?

Michael Shekel: Absolutely. I think going back to what Nicole just mentioned, at the end of the day if you look at the publicly traded BDCs, you always see that their stock is traded typically at a discount to their NAV, and so there's a lot of fascinating theory of why it's not occurring on a daily basis. It goes back to the transparency of information and the challenge of whether the fair-value analysis, and there's many, many players involved of why is it traded at a discount or even a premium on some exceptions? So that's definitely a challenge.

But also just to emphasize, I think one of the big part of the decisions is really the data they have to produce, and the yield that they have to produce for their own investors. And so it's what I call a big machine that has a lot of inputs and assumptions on investments in the industry to kind of go into it. But at the end of the day, the purpose is going to serve the middle markets. And at the end of the day, I think overall the purpose has being served. It's just there's some issues, particularly the valuation and the data, how do we make sure that going forward as an industry we can improve and enhance that particular process?

Mark O'Brien: Yeah, great. So let's get into that. We had a really interesting conversation as we got together to talk about this discussion about that very issue. So Kelly, you mentioned marked to market. Nicole, you talked about valuation. Michael, you just did as well. So for me, I find it interesting. Again, I'm sure our listeners know that these are 40 Act entities, and so the question I ask as we were chatting the other day is why aren't these valued every day? Why aren't they treated like mutual funds? And why aren't they obligated to do daily valuations, generate net asset value?

So what would be required? What would be the considerations to facilitate daily valuations? What are the risks to investor given current quarterly value? Nicole, I thought you had some really good insight when we were chatting about this the other day, maybe you could kick off the discussion.

Nicole Eisenberger: I'm happy to. But I have to tell you Mark, that kind of talk is scaring a lot of BDC managers right now. What they have to do on a quarterly basis isn't for the faint of heart, I can't imagine having to do it on a daily basis.

But I'll take a step back, I'll first highlight some of the differences between some of your registered funds like mutual funds and a BDC. In a mutual fund, generally you would see those being invested in what we would call a level one or level two investment. And so in the hierarchy for fair-value, there's three levels. And level one and level two are significantly more easy to value than a level three.

So what's a level one? A level one has a readily to terminal market, like a stock. It's trading regularly, you're able to determine what the fair-value of the security or asset is fairly easily. Level two, it's a little more difficult but also there is some sort of market. There could be bids. Even when models are built, most of the inputs are observable like interest rate, discounts, and yield curves. And so the information itself is more available but as you go down the hierarchy, then you have level three.

And the BDCs are largely in this level three space. What the level three investments essentially are, those are the least transparent, the most difficult to value. There is no active market, these are private companies, they largely rely on complex models to determine their fair-value, and that the inputs to those models are generally unobservable. It relies on local market data, data from the portfolio company themselves and so it was a lot of subjective assumptions in those valuations.

So now that we've defined those three buckets, if you think about a mutual fund cutting a daily NAV, okay, I can get my level ones pretty quickly. Level twos, not as easily, they don't have as much of that in their portfolio. But again, there's still a market, there's still [inaudible] quotes. They can still not allow it and largely be able to track the market more easily. When you get to level threes, this information is very clunky, very difficult to get. They struggle on a quarterly basis often to get that information hat they need to have meaningful values. So to try do that on a daily basis, rather complex.

Now that said, I have seen a few funds go out there with level three investments and cut a daily NAV. They're far and few between but those firms do struggle, and in order to accomplish that they build models that track indices, the market activity. It's at a higher level and try to track and cut their NAVs based on that. I struggle with some of the valuations. You're not getting updated market data from the portfolio companies as readily. So it's flawed but I know Michael can certainly add a lot about how those valuations are arrived at and why it's complex. But I think that largely speaks to your question, why you don't see them cutting a daily NAV. I don't know about the quality of the data if they were to cut a daily NAV.

Mark O'Brien: Right. Yeah, it's good feedback. I can see your point, it can almost be counter productive in some respects. Michael, why don't we go to you, maybe you can talk a little bit more about the process. And again, hopefully this is beneficial to our listeners, but again as service providers these are things that we find are important and hopefully you our listeners do as well. So Michael, why don't you maybe launch into a little bit more detail about the process.

Michael Shekel: Sure. So as we discussed before, the availability of information is key for privately held business. When we talk about level three, as Nicole just mentioned, it's definitely an involved process. For those that are for daily valuations, that's certainly something that we all strive for, but at the end of the day it's going to be very challenging. Just like Nicole said, there's definitely some players in the market that try to do that, and I think it's probably doable to some extent. But as soon as you hit an economic shock just like we are experiencing, the COVID-19, then the data becomes almost impossible because the data is just not there to support. If the interest rate was 10% yesterday, during COVID-19 you could have many variables that could push it up and double it. So it's very challenging to do that, especially in distressed situations. But hopefully we can all strive to get there at some point.

So from our perspective, Cherry Bekaert is really conducting quarterly valuations for quite a few BDCs, privately and public, and the process is certainly involved. Again, we're not talking about Microsoft or Apple, the data's just not there to get it on a daily or seconds. And so the first step is really one we do with our clients, is really try to bridge, again as we mentioned, the direct pricing, their fee. There's a lot of technology out there from third party pricing providers [inaudible] so we can really on that? Or do we have to revert back and call it a true level three, as Nicole mentioned, and really go through the valuation process?

And so as mentioned, typically BDC investments in the form of equity and debt positions in portfolio companies across the industries are level three. And so what we really need to do is make sure that we understand the correlation between enterprise value of the subject offering business and the debt or equity position. Enterprise value is a critical piece of that puzzle. Leverage financing, leverage lending, enterprise value plays a critical role and I can't really emphasize that enough.

And so when you talk about enterprise value of a privately held company or entity, it's a process. You really have to apply and consider all the valuation methodologies, the market, to assets, to income, and really start there and see what is the enterprise value and what does it support in terms of the capital structure [inaudible]. Obviously if it's a first lien, and it's performing, and the enterprise value supports it, it's pretty much a straight forward analysis. If the enterprise value is based on five, six, seven times EBITDA and the leverage of the first lien is two to three to four, then I think we're pretty safe to say that it's straight forward.

But once you get down to the lower level of the capital, second lien, mezz level, or equity, then you really have to do a risk analysis really at the investment level. But again, it's highly correlated to the enterprise. And so once you get to an enterprise value, then we have to really understand the attributes of the specific investments, whether it's debt or equity. You really have to scrub the credit agreement to make sure that we understand the features. Make sure if there are any significant amendments, we have to capture that on a quarterly basis. And then we have to ask the question, is it performing or not performing? If it's performing, then we typically revert back to the typical valuation analysis and methodologies using the market yield, or the credit, or synthetic credit, based on corporate bond. And if it's not performing, then we go back to scenario based, trying to capture potential liquidation, potential amendment, significant amendment, restructure.

I know we're going to discuss this a little bit later if we have time, but one of the impacts of COVID-19 is really kind of forcing the players to look that scenario base. Because there's a lot of uncertainty, especially when the EBITDA does not capture or does not support the capital structure in its entirety. Then you really ask the question and say, "Okay, what's next? Is it restructuring? Is it a key amendment? Is it really a liquidation? Are we that distressed that we're going to through a fire sale?" And so forth. And so as you can see, the valuation process is fairly involved and we value about 100 to 150 positions on a quarterly basis. To do it on a daily basis would be a significant challenge for sure.

Mark O'Brien: For our listeners, I hope you have a new found appreciation for the process because in all seriousness it's a very complex process. It's a very well thought out and very detailed process, I don't know how else to say it. Kelly, anything you want to add? I know this certainly isn't my area of expertise, I know you've got some perspective though. Any further comment you want to add on this point?

Kelly Thompson: I guess I would just say that obviously the smaller the company, the harder it gets. In direct lending, it's so hard to get comps. I mean, that's what I'm asked for all the time, is like, "Do you have any comps?" "Have you seen any deals in this industry?" "Do you know what pricing was on that deal?" Do you know what leverage was on that deal? It's very difficult to get comps on really small lower middle market businesses.

I would say maybe it's a little bit easier than traditional middle market to upper middle market, but again I think a lot of the valuations too, the management's experience is definitely piece that also goes into-- how long have they worked with this management team? What's their feeling on how these people are going to manage the business going forward? I think that's also something that probably weighs more than you would think when they value those at quarter end. Yeah, it's definitely an art and science.

Michael Shekel: Yeah. Kelly, I think you raise a very significant point. At the end of the day, especially during COVID-19, we were always trying to get management guidance in terms of what is the new normal for the operating business? Do we have up to date financial projections? What is the guidance? And at the end of the day, let's face it, it's a challenge for everyone. So without the guidance of management, it's a more challenging task. And so absolutely, management is key, market data is key, and putting it in a daily basis would be a significant puzzle.

Nicole Eisenberger: I would just add further to all the points is that because of that difficulty, different management is potentially going to have a different point of view on the value. Something Kelly and I have talked about in the past, why would you even see two different values for the same investment? If it's fair-value, shouldn't it be the same?

And yeah, generally they should be in the same ballpark, but you have to understand that the perspective of those valuing it and the information that they have available to them or what they're putting into the judgement part of arriving at that value, who's to say which one's more right than the other? And it's really very key where I sit, and both those managements, wherever they're sitting, wherever they arrived at, that they were very thoughtful in their process, they used the best information available, they looked for any contrary evidence in the market in arriving at their value. And often they can both support the values even though they're not the same, as logical as that might seem. But it's very difficult, you see that, now try to do that on a daily basis. And we do see that type of divergence from time to time. It's not often, but from time to time on the quarterly basis.

Kelly Thompson: In the first quarter there was one name and I'm not going to identify it, but there was one company and four BDCs held some of the first lien loan in it. And out of the four BDCs, one of them put it on non-accrual and the other three didn't. And so I talked to the firm that put it on non-accrual and I was like, "So what do you know that they don't know?" And they just had a much more conservative view on how things might play out in the second quarter or beyond or whatever, and they felt that they should put this investment on non-accrual.

Even just putting an investment on non-accrual varies from BDC to BDC. I've seen on some of them, they won't put an investment on non-accrual until payments haven't bee made for 90 days. Some of them will put them on non-accrual if there's been no payment for 60 days or 30 days. Some of them will put them on non-accrual, like this other firm, based on the fact they think there's trouble ahead even though maybe the payments are current. There's a lot of subjectivity to how managers value, what they think of these assets.

I remember in the first quarter, I just bring that up because I don't ever recall seeing that before. Usually values can differ maybe five points or something like that, or if it's a distressed assets there can be a large gap in valuations between BDCs that own the same asset. But I've never seen before one BDC put it on non-accrual and the other three didn't, that was just unique.

Nicole Eisenberger: Kelly, you bring up a great point about non-accruals. So again, why would a BDC put it on non-accrual versus not? Cash is not the only indicator whether or not they're getting payments currently. Because that payment, you can maybe call it interest but maybe they're just getting back their capital. Maybe it's all the money that they're getting and they're never going to see all the interest on this investment.

So another key indicator really is how that asset is being valued, so if it's significantly under par. So sometimes when they mark the investment down, you saw in Q1 huge markdowns. And you look at what the value of the investment is versus am I still recording interest? Cash interest income or pick interest income, whether I'm ever going to recover that. And that has to be taken into consideration.

I can tell you, if an investment is 50% of par, that's going to give me heart palpitation, you're on non-accrual status. What does that mean? Tell me your story. But in the 70-80% of par, and that could be where some of that judgement might be, maybe you're seeing the one out of the four taking a different point of view, how under water was it? Do they think it's going to recover? And should we turn off the spigot at this time or not? And cash isn't the only indicator, so I think value is very important. Because when they do get that cashback, where is it in the [inaudible]. What cash are you really getting back? That's where they have to determine, and that's largely what you're seeing in the differences in the Q1. Who knew?

Michael Shekel: You think we can answer all these questions on a daily basis? Maybe.

Kelly Thompson: Yeah, how do you value a loan of 50 million that doesn't trade on a daily basis? I don't know how you would do that.

Mark O'Brien: Yeah, what benchmark would you use, right? Because that's how a lot of fixed-incomes securities are valued. You benchmark it against the appropriate treasury, you figure out the premium, you look at [inaudible]. But yeah, these are very, very interesting points.

Michael Shekel: Yeah. If it's a two times leverage multiple and there's no COVID-19, maybe you could do that. But outside of that, I think there's a lot of other [inaudible] much too complex. And so it remains to be seen where the industry is kind of striving to go, and that's [inaudible]. But at the end of the day, I think we're definitely not there yet.

Mark O'Brien: Let's do a time check. It's 1:53 Eastern time. Maybe I'll throw it out to the group, our next agenda item was going to be the impact of COVID. You could maybe just take a few minutes, go around the table and provide our thoughts on that. Does that sound like a good approach? Michael, maybe I'll throw it to you first.

Michael Shekel: Yeah, so maybe just briefly so we all have some time. I think based on discussions with our clients, the key lessons that they've learned from COVID-19, and still learning, is really the importance of the sponsor support. Especially when holding a second lien and below, it becomes extremely important that the sponsor is there to support the business on a daily business as operations face [inaudible] issues.

As Nicole mentioned before, industry certification is key. Those BDCs that are in let's say, the oil industry, they're definitely thinking of reassessing, maybe they should explain some industry exposure. At the portfolio company level, I think what we've learned is real-time cashflow forecast is something that is becoming increasingly important, especially at the level of ... capital. Is there enough quarterly to keep the business going beyond the distress 90, 100, and 80 days of sale? And really focus on enhanced liquidity position, I think that's key.

Mark O'Brien: Got it. Maybe Kelly, I'll throw it to you, and then Nicole we'll give you the last word.

Kelly Thompson: I think going forward, I think non-accruals are sort of the main headline for BDCs. In the first quarter there wasn't a huge spike but I didn't expect as many as there were. So far in reporting for second quarter they're definitely up, and I would say generally across the board they're up, even for really experienced managers. Big disparity you see is that BDCs with 4 billion in investments or more definitely weathering COVID much better than BDCs that are targeting lower middle market businesses. Some of those BDCs that are focused on lower middle market, some of them have double digit non-accruals right now.

I think everyone had been expecting to see a big spike for second quarter non-accruals, the big question mark is 3Q. I think managers have a good idea of where the existing portfolio stands right now, and who's going to make it, and which sponsors have stepped up, and what the plan is, and there have been amendments. I have heard for quarters, so not years, so that's a good sign. But I still think the real pain isn't going to be seen until third quarter comes out. Because by then we'll know if there's going to be a really big impact from a potential second wave and another round of business shutdowns. I think that's a huge question mark that managers are struggling with right now. Is what happens if we go through another business closure cycle and how long would that last? The other big question is, when's the vaccine coming out?

So forecasting where busines is right now is really difficult. Even just in the businesses that have reopen, okay, well revenue's back 50% but does that mean a year from now it' going to be back 100%? I don't know. It's really difficult to say and I think lenders are having a really hard time with what to underwrite going forward. And so I think activity is still going to be pretty muted in terms of new issues, and I think that managers believe they might not have seen the bottom yet potentially.

Mark O'Brien: Nicole, why don't you take us home. What's your view?

Nicole Eisenberger: Sure, largely I echo what I've heard. But in addition I would like to say that if you looked at Q1 for example, huge discounts, 10% discount for uncertainty. That was by and large across the market, and there was a lot of unknown. As you move into Q2, there's some resolution, still unknown but there's some resolution. Meaning some of those companies, they're gone, they didn't survive, those loans are being written off, they're not going to recover. And then you have those portfolio companies who are thriving in this environment. They are in industries or have pivoted to fill a gap to react to the pandemic, and those companies are thriving. And so you see the resolution of those two in the second quarter.

What's going to be most interesting, and I think to Kelly's point in the third quarter, are those companies in the middle. And the duration of this pandemic and the recovery thereof is really going to play a large role in those valuations whether those companies are going to survive, many are on life-support. And really how long this lasts is going to affect whether or not those investments are going to come out of this okay. And that's really where a lot of the managers are spending their time, they obviously have to track investments very closely.

It could be month by month, quarter by quarter data that's coming up from the portfolio companies. They're getting more data from the portfolio companies now than they were initially, but it's really going to fall in that forecasting. No one has a crystal ball, wish we did but no one really knows. And so it's going to be best guess, educated, but best guess as we see when we get into the third quarter. And some BDCs are audited, report at year end at the third quarter. It's not their third quarter. So it's going to be very interesting to see how that plays out in the months to come. I think we're not done yet but I think there's been some resolution. So it's just those middle investment I think that are going to continue to be volatile in our market that we're going to see.

Mark O'Brien: Got it. Thank you. With that, we are on the hour. I think at this point we'll close. I must say this has been a lot of fun. Nicole, Kelly, Michael, thank you, this has been not only an honor but a pleasure to spend some time with you and with our participants. So thank you to the AICA for giving us an opportunity to do this. Thank you the participants for listening. I'm sure the AICA will give you our contact information if you want to reach out to us individually, but for now, thank you for your time. We appreciate your participation, enjoy the rest of your day and the rest of the conference. With that, thank you and goodbye.

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