

# BDC Industry Evolution to Favor the Largest Players

By Jennifer Banzaca

The BDC industry will evolve toward favoring the largest players who can make use of their scale to both address more attractive parts of the market and leverage their cost bases.

During the BDC Institutional Investor panel at the Active Investment Company Alliance's (AICAlliance.org)'s Summer Summit on August 13th, Michael Petro, a Portfolio Manager of the Putnam Small Cap Value Fund, said the market will also favor players who can exploit specialized acumen and relationships in more niche parts of the market.

"Not to suggest that middle ground BDCs are doomed, but rather that statistically the deck is somewhat stacked against them. Middle ground BDCs will have an opportunity to compete, but if they don't avoid 'me-too' originations they will 'just' need correspondingly better management to generate strong returns in a tougher, more competitive part of the market. Statistics are real, but they aren't fate," Petro noted.

Troy Ward, a managing director at Ares Management, agreed middle ground BDCs could be in trouble but added that there will still be a place in the market for them.

"There could be a middle ground BDC, as long as they know who they are and who they're not. I

think quite honestly any size can be successful if you have the right team focused on the right areas."

When discussing the future of the size of the industry and its direction, Petro said he believes there will be a bifurcation, likely across most industries, where the large players get bigger.

He also noted that there will be a place for smaller BDCs.

"They have a low cost to capital and they're playing in a space where frankly the big guys would have to underwrite 150 or 300 names to move their needle," Petro said.

Petro said he thinks the middle ground BDC will "get killed" as they are too big to really be playing the SBIC angle and too small to be getting the scale and cannot write large checks.

As to what the right size is for a BDC, David Miyazaki, a Portfolio Manager at Confluence Investment Management, said bigger is not always better.

"The biggest determinate really is the quality of the manager, the alignment with the shareholders, they know who they are, they know what they do, and that's really of paramount importance."

Miyazaki said it is really important for a manager to know what they do and what they're good at, as opposed to trying to go all over the place up and down the capital stack, across different industries, getting bigger and bigger.

"You've got to know who you are and you've got to be good at what you're doing," Miyazaki said.

The difficult market could also spell the end for some zombie funds, although some will persist, Ward predicted.

"It's really hard for M&A in the space for a lot of reasons, especially because of the external management in most of them that make it difficult. And, if you're a manager of a BDC, do you really want to be taking on the underwriting of somebody else who's already failed? So those portfolios are probably under a lot of stress. They've already been worked, so you probably have adverse selection. It just makes it really hard. So zombies, unfortunately some of them will be out there for a long time."

As to what makes for a good BDC investment, it comes down to good management and transparency. It's also useful to look at the NAV change over time.

"First and foremost, you own the manager. So understand who you own, understand why they're building a portfolio the way they are. And you have to have comfort in that. Beyond that, we love to see transparency and obviously the BDC model by itself provides a lot of transparency for investors. But then secondarily is the additional transparency and the way the manager can slice and dice how they're doing business, and as an investor, as a shareholder, how it can give you insights into what they're doing," Ward noted.

Petro said the kind of BDC his firm invests in depends on the cycle.

"I am willing sometimes to buy less than the best BDC just because I think that that's the right time to buy it and to make money. You don't have to be married to these, you don't have to own them for five years. I think that's a perfectly fine strategy, to pick the BDCs and you own them forever."

Miyazaki noted that when looking at any financial company, the most important assets "go home every night."

"Management is clearly going to be of paramount importance. As you look at the track records of the different management teams in the industry, you see a pretty wide spectrum of outcomes. From our perspective, what we try to still keep a focus on are the high-quality managers."

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