BDCs Are Well-Positioned To Handle Fed Policies And Recession

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mickey Schleien, managing director for equity research at Ladenburg Thalmann & Co. Read the Q&A below as Mickey says that business-development companies have seen the rising interest-rate environment lead to higher yields, which has helped to offset declines in net asset value that BDCs have suffered as a result of the Federal Reserve's tightening monetary policy. He says that middle market companies have seen revenues and earnings grow about 11 percent at the start of this year, without endangering their distribution or suffering through a lot of defaults. Schleien says that BDCs have managed credit trends well enough to now represent an attractive opportunity even as the economy heads toward a recession and despite the sector broadly being fully valued.

Mickey Schleien

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Mickey Schleien, managing director for equity research at Ladenburg Thalmann & Co. is here, and we're talking business-development companies and how they've been impacted by the rising interest rate environment, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're pointed directly at BDCs, business-development companies with Mickey Schleien, managing director for equity research at Ladenburg Thalmann & Co., and you can learn more about the firm at Ladenburg.com. To learn more about closed-end funds, interval funds, and of course business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. Mickey Schleien, welcome to The NAVigator.

MICKEY SCHLEIEN: Hello Chuck, thank you for having me.

CHUCK JAFFE: Let's talk generally about BDCs and a rising interest rate environment. Because the Fed has been tightening monetary policy, it's affected everything, but truthfully BDCs are all about, what are you able to get and how they respond to interest rates, so what's been the impact?

MICKEY SCHLEIEN: That's a very good question, Chuck. Rising interest rates have a couple of impacts on BDCs, a lot of BDCs focus on investments in first lien floating-rate loans, that means they have the highest claim on the borrower's assets, which reduces risk, and the loan's pricing goes up and down with base interest rates like an adjustable-rate mortgage. The Fed's been very aggressive in raising rates to reduce inflation, they've raised the base interest rate, which is called the Fed's Fund Rate, from about 0.1% at the beginning of last year to about 5.1% now. That's a total increase of 5%, and it's increased the average yield BDCs are getting on their portfolios from about 9% to about almost 13%. They've passed that on to their shareholders with higher dividends, and the average dividend yields on their shares has increased from about 9% to 12%. The other major impact has been on BDC book values, which are also called net asset value or NAV, since BDCs are closed-end funds, they need to estimate the value of their portfolios every quarter. There's a lot of data that goes into estimating NAVs, one of the most important inputs is a comparison of the pricing of a loan investment already in the portfolio compared to how that same loan would be priced in today's market. As I already mentioned, BDCs focus on floating-rate loans and they're priced on a spread above base interest rates, those spreads have gone up as investors have gotten more concerned that the economy will slow down. That increase makes the loan already in the portfolio worth less on paper, which impacts NAV. At the median, BDC NAVs have declined by 6% since the Fed began to tighten, but a lot of that is from unrealized paper losses which could be recaptured if things improve. Since the beginning of last year the S&P 500 has had a negative total return of -7%, while BDCs have had a slightly positive total return, so they've outperformed nicely in a difficult environment.

CHUCK JAFFE: What's been the impact to the portfolio companies? So you talked about the impact on the BDCs themselves, but obviously the companies that they're putting their money into are being impacted as well by rising rates, so how is that next connection level?

MICKEY SCHLEIEN: BDCs focus on making investments in what is known as the middle market, which are companies with earnings of less than $100 million, it's an important group and represents about a third of the US economy. When the Fed began tightening, there was a lot of fear that companies couldn't handle both climbing interest rates on top of dealing with a high rate of inflation, and that that would lead to problems for them being able to pay the interest on their debt. One of the biggest surprises has been how well they've done in dealing with those headwinds. As of the first quarter of this year, middle market companies saw their revenues and earnings grow about 11% on average, compared to a year ago, that's a good rate of growth. The ratio of their earnings to the interest they pay was about 160%, so they still have a lot of cushion against rising rates.

CHUCK JAFFE: Let's now turn that around from what's happened to what's likely to happen. What's your outlook as we've got this pause in rates for now, we've got an economy that most people think is going into a recession, how hard the landing will be up for debate, but what's your outlook for what it all means for credit quality?

MICKEY SCHLEIEN: BDC managers tend to be a pretty conservative group because as a lender it's really hard to make up for a loss on a deal, their portfolios tend to be defensive with concentrations on areas like software and they stay away from cyclical industries in general like consumer products. When a borrower stops making interest payments, or if the BDC feels there's an expectation they won't be able to meet those obligations, they put that loan investment on non-accrual, which is one measure of credit quality. These non-accruals were 2.5% of BDC portfolios as of the first quarter, and they've held steady at that level over the last year more or less. In the financial crisis non-accruals peaked at 6%, and during the pandemic in 2020 they peaked at 3.5%. We don't think the current economy slowdown is anywhere near what we saw in the Financial Crisis, and it's hard to compare to the pandemic because the government pumped so much money into the economy, but it seems reasonable to assume that non-accruals could climb about another 1% as the economy slows. But it's important for investors to remember that on average BDCs keep about 70 cents on the dollar even when a first lien loan defaults, so other than one-off situations, we think BDCs can manage these credit trends.

CHUCK JAFFE: Is there good value at this point in BDCs? I mean, what are we looking at in terms of valuations now versus where valuations historically have been?

MICKEY SCHLEIEN: BDC shares tend to be driven by their dividend yield and the ratio of their stock price to their NAV, which is their book value. Over the last five years they've traded at an average dividend yield of 11%, and about 96% of their NAV. With the market's recent runup over the last few weeks, they are trading near those averages, which looks pretty full against the potential for a recession.

CHUCK JAFFE: We gotta ask, are there a couple of names, a BDC or two that you particularly like right now, that given their valuations relative to an industry that's relatively fully valued you might be considering?

MICKEY SCHLEIEN: So when the sector's fully valued like it is now in our opinion, stock picking becomes more important. One name which I cover that I think investors should look at is Owl Rock Capital, it's ticker symbol is ORCC. At the current price the stock is trading at a 10% discount to its NAV with about a 10% dividend yield, which is attractive. Besides its valuation, another reason I recommend Owl Rock is that I think the company is in the position to withstand an economic downturn. First, Owl Rock is part of a large platform called Blue Owl, which has over $70 billion of assets under management in its direct lending segment, that is one of the larger platforms among BDCs and it provides it with a deep bench to identify investment opportunities and to manage problems. Another reason I recommend Owl Rock is that it's focused on lending to large companies, as of the first quarter their average portfolio company at earnings before interest appreciation and amortization, which is also known as EBITDA, of over $175 million, which compares to a more typical BDC portfolio company of somewhere around $30-40 million, so Owl Rock's higher EBITDA in their portfolios companies can help reduce credit risk. The fund is also outearning its dividend, in the first quarter they reported EPS of 52 cents, which was well above the 37 cent per share dividend. Finally, the companies have been repurchasing its stock, which we view as a sign of management's confidence in both the portfolio and the attractiveness of the shares. So that's one idea in the current market that I will suggest your listeners pay attention to.

CHUCK JAFFE: Mickey, this has been great. Thanks so much for joining me on The NAVigator.

MICKEY SCHLEIEN: Thank you, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, that's me, check out my hour-long weekday show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and of course business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Mickey Schleien, managing director for equity research at Ladenburg Thalmann & Co., the firm is online at Ladenburg.com and on Twitter @LadenburgLTS. The NAVigator podcast is new every Friday, follow along on your favorite podcast app to make sure you don't miss an episode. We look forward to bringing you more closed-end fund talk next week, and until then, happy investing everybody.

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