Oppenheimer’s Penn: BDCs Have Adjusted To Higher Default Risks

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mitchel Penn, managing director of equity research at Oppenheimer and Co. Read the Q&A below as Mitchel says that higher interest rates and stubborn inflation have impacted business-development companies in terms of both defaults and leverage, but he notes that BDC executives have taken steps to minimize the impacts. Moreover, current conditions should have BDCs primed for better returns than they could deliver during low-rate times; Penn also names five BDCs worth considering now.

Mitchel Penn

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

CHUCK JAFFE: Mitchel Penn, managing director of equity research at Oppenheimer and Co. is here, we’re talking about the impact of the economy on business-development companies and this 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, 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 looking in the direction of business-development companies with Mitchel Penn, managing director of equity research at Oppenheimer and Co. You can learn more about the firm at Oppenheimer.com. And to learn more generally about closed-end funds, interval funds, and yes, BDCs, go to AICAlliance.org, the website for the Active Investment Company Alliance. Mitchel Penn, it's great to have you back on The NAVigator.

MITCHEL PENN: Thanks Chuck, it's great to be here.

CHUCK JAFFE: Jumping in on BDCs gets me to ask a question that I have loved asking anybody who's working with risk assets, because the one thing we have not seen much of as we've watched interest rates rise is the one delayed thing that we sort of always assume will happen, which is rates go up, somebody can't pay their bills. But we haven't seen junk bonds become junky and we haven't necessarily seen a lot of defaults, or non-accruals as they like to use in jargon, among BDCs. What is going on? Is this it's not yet time, like they haven't come here in the cycle? What's the state of BDCs and their default risk right now?

MITCHEL PENN: Now that's a great question, and we get asked that question a lot by investors, and there are two main factors that investors are looking at in regard to that. First is, the Fed's raised interest rates quite a bit, and BDCs borrow money in the capital markets, and the cost of borrowing will likely go up. Now we've looked at that and taken a look at what bonds are maturing, and we estimate that the cost may be two to six cents for a BDC over the next year or two, which isn't very much at all. So the increased cost of leverage is relatively minor, especially given the increase in income that they're seeing from the higher rates. The other issue is what you mentioned, are we going to see an increase in non-accruals or defaults? And we do believe that we're likely to see an increase in defaults, a lot of that has to do with the Fed having raised rates so much. The interest coverage ratios of the borrowers have come down, but what's really interesting, the BDCs have already reflected the increased defaults in their marked to market. So BDCs have to mark to market their loan portfolio, and as interest rates have risen, credit spreads have widened, and as those credit spreads have widened, BDCs have marked down their loan portfolios. And as of the current quarter, the average BDC we cover has marked their loan portfolio at 96% of cost, so they've taken about a 4% credit reserve, and we think that that's enough to cover the potential increased defaults you could see over the next couple of years from the higher rates. So we don't think that the defaults will impact NAV, but we do think that you'll see increased defaults. And by the way, we did see that in Q2, we had very high realized losses, but those losses were offset by reversal of unrealized losses that they had taken in the past. So yes, it's an issue but we think the BDCs are well positioned given the marked to market to deal with those higher defaults.

CHUCK JAFFE: How are they positioned to deal with the higher cost of leverage? Because that's the other impact we would expect from higher rates.

MITCHEL PENN: They're going to see a little higher cost, but we estimate that anywhere from two cents to six cents, so it's not going to be material over the next year to two years. When you think about it, all their bonds are basically spread out, so they don't all mature at one time, they try to have 20% mature in one year, 20% in the next, and 20% in the next, and so you get like a five-year ladder almost, so it gradually increases over time.

CHUCK JAFFE: Interesting. Now we're seeing all of these changes at a time when it's kind of been a mixed year for BDCs, so what do you see happening broadly for BDCs as an asset class? And then maybe we'll follow off of that to what you're looking to do next and what you're maybe not playing in in the BDC space.

MITCHEL PENN: So what we're saying to folks is understand what you own. This is a good time, BDCs have done well this year, take a look at what you own and just make sure that you want to own these going into next year. And what we would recommend is just rotate into our buy-rated names, and I'll just give you five of the names that we like. We like more than that, but just for brevity we like Owl Rock, it's now Blue Owl with the ticker OBDC. We like Oak Tree, OCSL, Golub, GBDC, Ares, ARCC, and Sixth Street, TSLX. All those companies, they're good credit underwriters, they have strong ROEs that are above their cost of equity capital, so they have a long track record of good performance. And so we recommend to your listeners that they take a look at what they own, and if those BDCs haven't performed as well as they'd like, to take a look at this and rotate in, and take the tax loss if you have one. It's tax-loss season, so we recommend just taking a tax loss and moving into these higher quality names.

CHUCK JAFFE: Tax-loss season, this is of course what folks do. But this year I would assume it's going to be a lot tougher to find the tax losses, which should really spur anybody that's got one, yeah, go ahead. Or have there been more losses than have registered on my radar?

MITCHEL PENN: With BDCs, there are gains this year, but last year there were quite a number of losses. So some folks may have not taken 'em last year, you might have some left this year to take. That's all.

CHUCK JAFFE: And generally speaking, your outlook, do BDCs perform differently? Like is your expectation for what the asset class and the average participant can return, do they perform differently in a high-rate environment than they did in the low-rate environment we were in for so long?

MITCHEL PENN: Yeah, I think what we're seeing is that the return on equity has been a little bit higher given the higher rates, so BDCs invest in floating-rate loans, as interest rates have risen, they've risen quite a bit, the BDCs are earning more. What's interesting is, if the Fed is able to have a soft landing then you won't get the high credit losses that would impact returns. Remember, the BDCs have marked their portfolios at 96% of cost, so they can absorb 4% losses. Which by the way would be sort of a mild recession, if you compare it to 2008, the credit losses were 10%, that was a fairly significant recession. In the first quarter of Covid when Covid hit, BDCs took 7% losses, now they did recover that as the government stepped in to help the economy out, but the point is 4% losses would cover you in a mild recession, and so the BDCs would have fairly strong ROEs. If you have a BDC that's trading around book, you could see about 11% dividend yield, and then on top of that you'd probably have a little bit of appreciation, anywhere from 5 to 10%. So the returns are pretty attractive, especially given if you believe that the average return on equity is around 6% per year, I think Buffet tends to quote that. We think that it's an attractive way to earn a return, and for folks who need income, it's very attractive.

CHUCK JAFFE: Mitchel, really interesting. Thanks so much for joining me on The NAVigator to talk about it, I'm sure we'll talk again down the line.

MITCHEL PENN: Okay, thanks Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yeah, that's me, and you can check out my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and 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 Mitchel Penn, he's managing director of equity research at Oppenheimer and Co., and you can learn more about the firm and Mitchel at Oppenheimer.com. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following on your favorite podcast app. And if you like this podcast, please leave us a review and tell your friends, because that stuff really does help. Until next week when we talk more closed-end funds, happy investing everybody.

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