What Struggles In The BDC Market Portend In A Changing Rate Cycle

Thursday, March 28, 2024

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Nicholas Marshi, editor at the *BDC Reporter*. Read the Q&A below as Nicholas talks about the struggles business-development companies (BDCs) had at the end of 2023, saying he was shocked to see that more than a third of the BDCs his publication tracks were "performing below reasonable expectations regarding their key metrics." He says that troubles tend to spiral for a few quarters before they get sorted out. Marshi also notes that no BDC has cut dividends yet, leaving "a really wide disparity of value between the BDCs" and making this a classic stock-picker's market in the space.

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

CHUCK JAFFE: Nicholas Marshi, editor of the *BDC Reporter* is here, and we're talking about the struggles business-development companies had last year and whether they're changing things in 2024, 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, and also business-development companies. 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 will point you in the right direction. And today we're looking in the direction of business-development companies, and we're doing that with Nicholas Marshi, he's editor at the *BDC Reporter*, which is a daily online publication that covers all developments in the business-development company space, and you can learn about it by going to BDCReporter.com. And if you want to get more information about BDCs, but also closed-end funds and interval funds in general, check out AICAlliance.org, the website for the Active Investment Company Alliance. Nicholas Marshi, welcome back to The NAVigator.

NICHOLAS MARSHI: Oh, very glad to be here.

CHUCK JAFFE: We are in an interesting time for business-development companies. Quite honestly, they did struggle I think a lot more than people expected them to in 2023. Because we have this good space, higher for longer on interest rates, and on the one hand that can be a challenging environment, and on the other hand you'd think it would make them perhaps a little bit more attractive. Where do you think generally BDCs are right now and as we get into a change in the rate cycle?

NICHOLAS MARSHI: As you said, the fourth quarter was a bit of a surprise, you know? We had avoided the recession that everybody had talked about in '23, which is obviously good for BDCs because there's less bad debts, interest rates were high, the highest level they've been in in years, so BDC earnings should have been, and were in many cases, at highs. But when we saw the fourth quarter reports, and we track every single BDC, and we give them all a score between one and five, and there were 43 that we were looking at, we were shocked to see that 13 BDCs out of 43 were performing below what I would call reasonable expectations regarding their key metrics, and that as I say was a bit of a surprise.

CHUCK JAFFE: Performing below, give us an idea of what you would have expected and what you saw, and is there a reason? That's a significant chunk of BDCs below expectation.

NICHOLAS MARSHI: And that's what makes it so interesting. So below in like three different categories that we look at; we look at earnings, we look at net book value, which really ties to credit, and then we look at dividends. Now let set dividends aside, no BDC cut their dividend, most of them have been increasing their dividend and adding specials, but in terms of earnings and net book value there were several surprises where relatively large BDCs and some small BDCs had lower than expected earnings in a year when it was very easy to not do that, and who saw their net book value drop by significant percentages because they had unrealized or realized losses. That's where the weakness was mostly in earnings and in net book value.

CHUCK JAFFE: When you see that kind of struggle, how long does that typically persist? Like what shakes a BDC out of those doldrums? Or is this more you get into a spiral, you stick in it for a long time?

NICHOLAS MARSHI: That is the key question, isn't it? Usually the spiral is what happens for several quarters until management really gets their hands on it and cleans things out. Some of these are going to be just one-time events, like one BDC for example had lost half of its net investment income in the quarter because they had to make an adjustment for a non-accrual that they had to put on at the last minute which hurt their income. But I'd say that in about two thirds of the cases we have what looks like a continually deteriorating credit situation, and in about one third we still have a hope of bouncing back, maybe because they've already worked their way through all their bad debts or because they're actually turning them around and taking them from performing poorly to performing normally. It's a mixed bag, I'm sorry to say.

CHUCK JAFFE: Throughout most of the financial world, you watch rates go up, you expect defaults to go up, and we haven't seen a lot of defaults going up in most areas of the bond market, you're not seeing junk get truly junky. But BDCs dealing with, in many cases a lot of lenders that higher rates put them under pressure, is there a default problem that's part of this issue? Is there a worry that we're going to get one for you?

NICHOLAS MARSHI: This time last year, all the BDC managers and all of the analysts and the investors were expecting that higher rates, and this is before rates really got to be high, were going to get stressed by all of that high debt service, because I mean some companies have seen their interest rates go up like five points, and that's a lot. Funny thing happened on the way to all of that disaster, it never happened, and we really haven't had too many companies get into trouble because their debt service is too high as the only issue. It's mostly because the companies themselves have done well in this inflationary environment and they tend to be well-run companies, and they've been able to increase their EBITDA, so they've been able to match their increases in debt service with higher income. That doesn't mean though that there aren't credit problems for other reasons, it's not only about leverage, and there have been some segments of the industry that have done quite poorly like in healthcare. A lot of companies in healthcare have got into trouble, and in retail as you can imagine, that's always getting into trouble, and so some of those troubles are coming to roost for the BDCs. Not for all BDCs, for some BDCs, but it's still something to worry about.

CHUCK JAFFE: Is there a next logical step for the ones that have become troubled? Like you know, if you've got a closed-end fund and it winds up seeing discounts widen, et cetera, you see an activist investor come in. But with a BDC, do you worry if they're getting into real trouble, does that make them a case where somebody might want to swoop in and take them over? Does that make them a case that they decide, we've had enough of this, let's rein the game, let's dissolve? What's the expectation? How much trouble are we talking and how does it play out?

NICHOLAS MARSHI: Yeah, I don't want to sound overly dramatic about it. As I said, no BDC has cut their dividend because of all of these troubles in the fourth quarter, and nobody is going to come over and take over a BDC against their will the way they're organized at the moment. What you're going to see is a lower net book value over time and that will bring down the stock price, and therefore in 2024 you're going to see a really wide disparity of value between the different BDCs. Some are going to be performing above a net book value, hitting record earnings and record distributions, while others are going to be struggling and just trying to get back to stability, so it means for investors that stock picking and paying close attention to what you're buying is going to be very important. In 2023 when rates were going up and everybody was increasing their dividend, it was a case of all BDCs were looking pretty good. That's not the case now, it's a much more varied landscape.

CHUCK JAFFE: Thanks so much for giving us a tour of that landscape. I look forward to chatting with you again down the line, Nicholas. Thanks so much for joining me.

NICHOLAS MARSHI: Thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I am Chuck Jaffe, why don't you 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 yes, business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. And of course you can learn more about business-development companies as well by going to the website of my guest, Nicholas Marshi, he's the editor at the *BDC Reporter*, which is a daily online publication covering all developments in business-development companies, check it out at BDCReporter.com. The NAVigator is new every Friday, though this week it's Thursday because of Good Friday, be sure not to miss an episode by subscribing or following along on your favorite podcast app. Meanwhile, have a great Good Friday and a fabulous week, and until we see you again next week, happy investing everybody.

Recorded on March 28th, 2024

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