CION’s Gatto: Money Rushing Into BDCs Creates Middle-Market Opportunities

Friday, July 12, 2024

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mark Gatto, Co-Founder and Co-Chief Executive Officer of CION Investment Group, which manages the business development company CION Investment Corp. Read the Q&A below as Mark discusses the heavy interest and cash flow into BDCs and how that is changing the space and making it important for investors and advisers to "pull back the layers to understand what they are investing in." Gatto advises paying particular attention to the deals and credit quality a BDC engages in. He also says that the biggest players in BDCs are becoming "very homogeneous" and avoiding differentiation when they get very large. However, Gatto says that situation also creates opportunities for investors who want to diversify their BDC holdings by investing in middle-market deals, where smaller BDCs can be more nimble and offer different exposure.

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

CHUCK JAFFE: We’re talking about what’s next in business-development companies with Mark Gatto, co-founder and co-chief executive officer at CION Investment Group, welcome to The NAVigator. This is 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 representing the entire closed-end fund business, 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, well, it's pointing us towards business-development companies with Mark Gatto, co-founder and co-chief executive at CION Investment Group, which runs the CION Investment Corporation, that's a BDC that trades under ticker symbol CION, C-I-O-N. And it also manages, among other things, the CION Ares Diversified Credit Fund, ticker symbol CADUX. If you're a fan of The NAVigator, you may recall that John Cole Scott of Closed-End Fund Advisors was analyzing that fund with us here last week. If you want to analyze what CION does, you can go to CIONInvestments.com to check out the firm and CIONBDC.com to learn about the BDC. And to learn more about closed-end funds, interval funds, and business-development companies generally, visit AICAlliance.org, that's the website for the Active Investment Company Alliance. Mark Gatto, welcome to The NAVigator.

MARK GATTO: Thank you, Chuck. It's great to be here, thank you for having me.

CHUCK JAFFE: I want to start with a bit of an outlook on business-development companies generally, because while they are considered an alternative investment, one of the things I've been saying for ages now is that alternative is not about where they are in the mainstream because these days most investors have some measure of alternatives and BDCs are becoming increasingly popular. So let's first kind of get your take generally on where we are right now with the BDC space and with investor demand for more action in BDCs, because demand is one thing, you still have to have the supply of all the right things that you're investing in too, right?

MARK GATTO: So yes, BDCs are extremely popular today within the alternative space because they really provide a lot of characteristics that investors are looking for. Most of the BDCs that are publicly listed provide strong income to investors, many of them are investing in private credit assets which is a very attractive asset class today; and unlike other alternatives historically that had very high minimums, long lock-up periods, weren't very transparent, the BDC structure is really favorable for retail investors because it allows them to invest in private assets, private credit specifically, without high minimums, with transparency because these are listed products, and they're liquid, so investors can move in and out of these structures on a daily basis. So it's a very attractive asset class, there's a lot of capital flowing into it, private credit has been performing extremely well for some time now, and although the economy is not as strong as it was previously, we still believe that private credit is an attractive asset class and investors can diversify their portfolio and diversify their fixed-income allocation by investing in these types of vehicles, and we're seeing that today, there's a lot of capital flowing into the business. Again, we think it's a very attractive asset for today's investor.

CHUCK JAFFE: There is a lot of capital flowing into the business, now that is a nice problem for any business to have, anybody would like that. And at the same time, if I'm an investor and I said, "Oh, you know, I want to buy quality companies," if that's my theme or my factor, you'd want to make sure you'd have enough quality companies out there. Given that we are talking, especially in many cases, middle market deals and things along those lines that are part of what BDCs are doing, do we have any sort of imbalance? In other words, a lot of demand with maybe not so much supply? Is that making it harder for a BDC to get in on the deals and the transactions it wants to be part of at reasonable prices, et cetera? Because a lot of money flowing in has to be put to work or your BDC is not delivering on its promises?

MARK GATTO: The private credit asset class is an enormous asset class, it's a plus trillion dollar market, so there's a lot of opportunity within private credit. As far as BDCs are concerned, you're looking at less than $200 billion of assets within the listed BDC market, but that doesn't tell you the whole story because there are a lot of private funds and other vehicles that raise capital to invest in private credit. But generally speaking, you're talking about an asset class that is extremely large and there's a lot of opportunity within that market. But I will say, what we're seeing today at the upper end of the market, there is a lot of capital flowing towards larger BDCs, larger asset managers, credit asset managers, and competition for the big deals, for what we would say the larger market, not the middle market, has increased tremendously. We're seeing tighter spreads, we're seeing less covenants and things that aren't necessarily positive for the market, but at the same time there are good deals, there are great companies out there, and companies will perform in different markets, and it's up to the BDC manager, the credit manager, to have the ability to identify those companies, underwrite those transactions, and price them the right way. Where we play at CION, we are more in the traditional true middle market, our target is companies that generate around $25 to $75 million of EBITDA, we think that's a less competitive market and you're not seeing the same dynamics that you're seeing in the larger market. And if you look at the 48-50 listed BDCs that are out there, we sit in the top half of that list with respect to our size and the AUM that we have under management, so we are a large BDC, but because we're able to be more selective and really narrow our focus within the middle market, we feel that we have a competitive advantage in an environment like this, but we are looking very closely at the supply-demand equitation and we're being very selective because of that.

CHUCK JAFFE: It's interesting to me because of course this is one of those things where if I'm looking at traditional mutual funds, they typically have a label that lets me know where they are in the credit spectrum and the rest, and with BDCs, well, they all carry the BDC label but clearly they are not all created equally. Do you worry at all, especially if interest rates stay as high as they are and the rest, that we will see more potential defaults that BDCs will be dealing with tougher credit conditions? Because we haven't seen junk bonds get truly junky, we haven't seen a wave of defaults, and yet inherently that's what we would have been expecting for a while now since rates have been higher for longer.

MARK GATTO: All managers in the space are looking at that and paying special attention to credit quality and how these interest rates are affecting borrowers, how the economy's affecting consumers and borrowers because they're related, and again it's a matter of being able to really select the highest quality assets, the highest quality borrowers within a particular segment that's going to really carry a BDC or any credit manager through this environment. That's why we think it's important to focus on, not only the BDC and its asset base and how much capital they have to put to work, but the platform in general, right? A lot of these BDC managers have very large platforms, they have a lot of capital put to work, in addition to what they're managing in their BDC, and that could result in things such as chasing deals, lowering credit standards, some style drifts and things of that nature. So you have to be really critical of the manager, what is their strategy, how do they do it, because all BDCs are not created equal, right? We all have different approaches, we all have different asset bases, we all originate in different ways, we look at different areas of the market, so it's important for investors and their advisors to really pull back the layers to understand what they're investing in and whether or not a particular manager is doing it in a way that they think is appropriate for their investor or for their portfolio. And I think far too often you're seeing advisors and investors say, "Okay, well, I'm already invested in a BDC, so I don't necessarily allocate capital to your BDC," and I think that's a very naive way of thinking about it. They really need to understand what each manager is doing with respect to the marketplace, how they're originating, how much capital they have to put to work, and I think if they can focus on those things, they're going to be able to identify the right BDC for them, the right partner for their portfolio. Because we all have to put money to work, investors want to get yield and they have to invest their capital, and there are quality managers out there, there are quality BDCs or quality businesses to invest in and lend money to, and we will see some defaults increase for sure, right? Because not every company can withstand the market environment that we're in, but that's going to be a function of again, the manager's ability to select the right borrowers, underwrite them in appropriate ways, structure the deals so that they don't default or they can survive through an economic cycle and come out on the other side.

CHUCK JAFFE: What you're saying here is that investors want to be diversified and that owning a BDC, not enough necessarily because you're not going to get full exposure. But as you see the development of the BDC universe, will we continue to see more of that differentiation? In other words, the group of the very large that you were talking about, and then more folks trying to do what you're doing in terms of whether it's true middle market or finding another area or saying, "Oh, I'm going to go into second lien financing and focus there," or whatever it might be, will we see more differentiation? In other words, is this going to be like ice cream where the more BDCs we see, the more it's going to be 31 flavors instead of just vanilla, chocolate and strawberry?

MARK GATTO: Listen, at the upper end of the market I think they're very homogeneous, I think a lot of them are doing the same thing and you're not going to see a lot of differentiation when you get very, very large, because in order to put that amount of capital to work you have to do the big deals, you can't be as selective, and that's going to result in managers looking very similar. In the middle end of the market to the lower end of the market I think you will see differentiation, and I think that's great for investors because it'll allow them to get exposure to different types of assets in a different way, and that will deliver the diversification that they're looking for within their portfolio. And I'd like to think that we're differentiated in the way we originate, in our approach, how we really target the true middle market, and we have the scale to be meaningful and an impactful player within that market, but we're not so large where we have to buy the market like a lot of other players. I think that allows us to be a lot more selective, a lot more nimble, and I'm hoping that we will demonstrate that through our performance over the course of time.

CHUCK JAFFE: Mark, really interesting, thank you so much for joining me on The NAVigator to talk about it.

MARK GATTO: Chuck, it was my pleasure and thank you for having me.

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, 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, that's the website for the Active Investment Company Alliance, they're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Mark Gatto, co-founder and co-chief executive officer at CION Investment Group, which runs CION Investment Corporation, a BDC that trades under the ticker symbol CION, C-I-O-N. You can go to CIONInvestments.com to check out the firm and CIONBDC.com to learn about the business-development company. The NAVigator podcast is new every Friday, make sure you don't miss an episode by following along on or subscribing on your favorite podcast app. We'll be back with more closed-end fun next week, until then, happy investing everybody.

Recorded on July 12th, 2024

To request a particular topic for The NAVigator podcast please send an email to:
TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more:
https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or* *investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*