Lead Left Interview – Jonathan Bock

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This week we speak with Jonathan Bock, CFA, Senior Analyst, Wells Fargo Securities. Jonathan is one of the foremost experts on BDCs in the banking industry / research community. The BDC Almanac (his primer) and the Wells Fargo BDC Scorecard (his quarterly) are the most read research reports in the market today.

The Lead Left: *Jonathan, CLOs are getting pounded by regulators. Are BDCs under similar pressures?*

Jonathan Bock: No. The BDC space is not subjected to risk retention / Volker etc. In fact, we continue to see growth in this space as a result of increased regulation on commercial banks and CLOs. Institutional demand in this space continues to grow as well-just based on the amount of calls I get from large pensions, mutual funds, and insurance companies.

TLL: *What's accounting for BDCs' popularity?*

JB: Even the stock prices have encountered a bit of short-term volatility (much like the markets), we still continue to see growth / interest pick up in the space. On the investment side, one of the keys is that BDCs are an inefficient asset class. Often you'll find that BDC equity often trades on a different frequency/wavelength than the loan collateral on balance sheet—all driven by the inefficiencies that come from this being a young industry. This gives investors a great opportunity to buy / sell the space at a point when equity is over / undervalued relative to the collateral aBDC owns (provided they understand the loan collateral). I've noticed this increased interest particular from members of the pension / family office community. These clients understand lending / credit, they have long-time horizons, and they appreciate picking up managers at prices that are both below NAV / FV. With regard to the attractiveness of the space on the manager side, a BDC is a permanent capital vehicle—*enough said*.

TLL: *I hear the market is talking about a very large event you have coming up in November…perhaps that's an indication of interest in the space?*

JB: Funny you should mention that event-I'm honestly shocked at the top clients / managers attending (including you Randy). It is absolutely stacked. This was an event we started last year to enhance dialog on the BDC space as well as the broader credit markets. Last year…I'd hoped for maybe 100 people. I ended up with over 350 (along with the logistical nightmare that created). This year… attendances will again more than exceed our capacity. I think I sent you asneak peak note on the event (and a full agenda will come out shortly)… When one considers the top managers who will speak at this event, as well as, all the fantastic LPs / investors in the audience-I'd imagine that's a pretty good indication of interest for the BDC space (despite the recent share pull back).

TLL: *For our readers, explain what the Russell thing was all about.*

JB: For those readers who might now be familiar, the BDCs were removed from the Russell 2000 indices in June. In short, it all stems from an SEC rule that funds owning BDCs must report those fees as their own. Vanguard purchased the CRSP [Center for Research in Security Prices] Indices, which had very low licensing fees. That meant any Vanguard fund following the index has an inherent cost advantage. Cost is everything.

TLL: *And Russell obviously had a competitive index.*

JB: As does the S&P 600. And because they own BDCs, you have to take the fund expenses and include them in your funds. So Russell had higher costs. Ironically, REITs are exempt from this ruling—so any externally managed REIT in the S&P 600 / Russell 2000 stays (even though it is fund for all intents and purposes.) Just boggles the mind that one…

TLL: *So how does this impact BDC prices?*

JB: Many BDC stocks took hits initially. Many traded below book value … recovered … and then fell to the levels where we are today (0.95x NAV). One could likely make the argument that the rebalance put shares into some weak hands and as BDC performance waned – this led to a bigger sell off as those weaker hands chose not to hold an underperforming investment outside of their benchmark. Still…perhaps a better byproduct of the Russell rebalance is that investors are differentiating more among managers than they ever have (based on fiduciary responsibility, ability to drive NOI growth in a senior secured asset class, etc.). This means some BDCs will attract capital and some will not. This differentiation is needed to help make the BDC market a "better neighborhood".

TLL: *The market has taken a pounding lately, but is still up since the crisis, so that's probably boosted the sector.*

JB: Sure…the market is down, but we've seen this move before. Believe it or not, relative to the S&P 500 earnings yield, BDCs now offer one of their highest spreads relative to the S&P since 2009. That would indicate that there is some measure of value in BDCs that market has currently overlooked. Think about it, BDC yields still present a great risk adjusted return (9-12%) while focused in a lower risk asset class (1^{st}lien, directly originated senior loans). Clients see the BDCs as an emerging asset class and many continue to be drawn to the space as it grows.

TLL: *What other advantages accrue to investors in the BDC world?*

JB: Wherever there are inefficiencies, there's money to be made. That's the case now between where BDC stocks trade, and where the collateral trades. Credit isn't falling off a cliff…yet these stocks are priced as if it will. Of course beyond that…investors that own the category today are building positions / intellectual capital in an asset class (i.e. liquid private assets) that will only continue to grow and become more relevant in the future.

TLL: *And by 'collateral,' you mean the underlying loans, correct?*

JB: Yes. Public investors – not just hedge funds and large asset managers – have the opportunity to back the right manager. The BDC category has the best amount of transparency of just about any credit strategy out there.

TLL: *There are certainly a lot of managers to choose from.*

JB: And there are plenty of tools available to the investor to break down mass sums of data. This is the part of the space I absolutely love. The data is a great equalizer. Here one can discern whether or not a manager is truly a direct originator or a pure 2^{nd} lien buyer of the desk. Research has come a long, long way in this space as more/ more people dive deep into the numbers to determine who deserves a low/high cost of capital. There's more work to be done…which is why I love my job.

To be continued the week of October 20

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