Why BDCs Matter (Part Two)

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In the first installment of our special report on business development companies, we reviewed their history, summarized the basic precepts that govern them, and discussed some of their key features. This week, we take a closer look at BDC structures.

As we wrote last week, BDCs are companies which issue stock to investors whose capital forms the equity of these entities. While BDCs are mostly owned by public shareholders, some distribute equity to private investors such as pension plans, sovereign wealth funds, family offices and other institutional funds.

This equity can then be leveraged with an equal amount of debt financing typically provided by banks. The cost of that financing varies depending on current market conditions, the nature of the BDC investments, and the reputation of the manager.

For senior debt-oriented BDCs, a good benchmark would be L+200-250 bps plus fees, for a total cost of capital of around 3%. For more yield-focused, junior capital vehicles, this expense would be in the 4% range, comprised of L+300-350 bps plus fees.

The bulk of a BDC's capital structure consists of investments in small and medium-sized companies. These BDC assets can span the debt spectrum: from first-lien term loans, to unitranche loans, second-lien term loans, subordinated debt, even preferred stock.

Of course, each asset category comes with its own expected returns and accompanying risk parameters. Banks that provide financing to the fund typically allow leverage on first-lien assets only. Yields from second-lien and mezzanine investments must stand on their own.

How much of each of the categories comprise individual BDCs? That's the secret sauce of the fund manager. Each manager's investment style and perception of market opportunities is different. We'll take a look at these characteristics later in our series.

Speaking of managers, BDCs have two different operating models: internal and external. The latter – which makes up the majority of BDCs – uses a third-party advisor that contracts with the company to manage the fund. Because that manager may have other clients, conflicts could arise. Advisors must be SEC-registered and are subject to other regulation.

Internal managers do not have to be so registered. And because they pay no advisory fees, operating costs tend to be lower. But, of course, they need to assemble the infrastructure themselves required to run the business, not rely on outside assistance.

Is it better to be a public or privately-held BDC? Both have advantages. Having access to public investors is certainly a plus, but if your stock price falls below book value, additional issuance can be inhibited. Private vehicles might seek investor diversification in the public markets, but probably don't miss being insulated from market volatility.

Next week: What role do BDCs play in the leveraged loan market?