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INSIGHT

VIEWPOINT

High Dividends and Opportunities for Growth in U.S. Middle Market Lending Through BDCs

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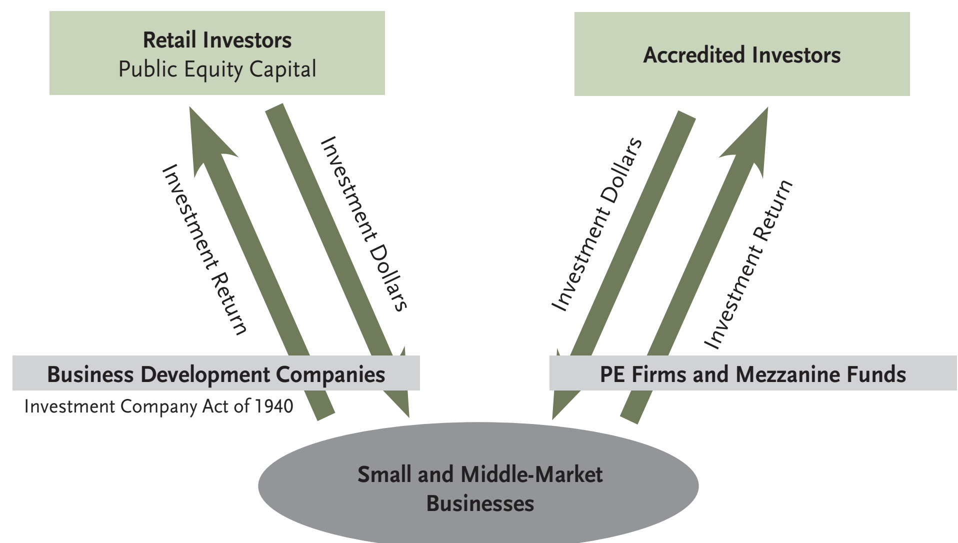
The demographic trend of the aging of the population makes it likely that income investing will remain a primary area of focus for decades to come. An interesting yet underfollowed niche within the realm of income equities is the U.S. Business Development Company (BDC) space, where companies routinely distribute dividends above 8% to shareholders.

The BDC model was created in 1980 when the U.S. Congress modified the 1940 Investment Company Act to facilitate private finance investment of middle market companies. At the time, bank balance sheets were stressed from the largesse of the 1970s, and middle-market businesses found themselves with limited credit options. In response, Congress created the BDC – a tax pass-through entity which would trade on public exchanges. The idea was to broaden U.S. middle-market lending to private investors, in a manner similar to the REIT structure for real estate.

The BDC Business Model



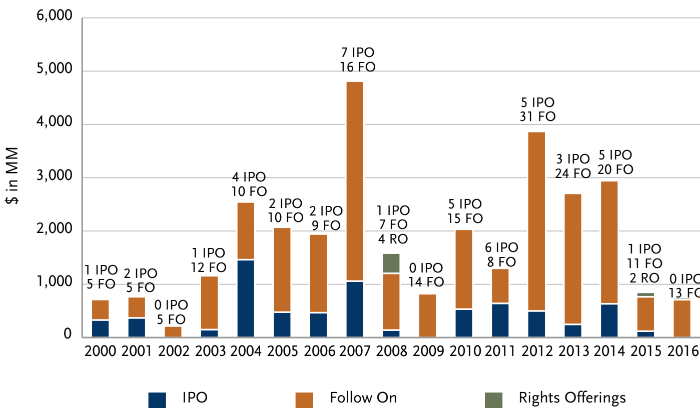
Source: Wells Fargo Securities, LLC

To maintain their tax-exempt status BDCs must adhere to a few rules, including limits on total leverage (total debt to total equity cannot exceed 1:1), and requirements on asset diversification, income, and distribution (they must distribute at least 90% of their gross annual income). Today, the publicly listed BDC space in the U.S. is comprised of ~40 companies with a total market capitalization of over $30B. Unlike REITs, the BDC structure has yet to gain widespread adoption outside of the U.S.

Most BDCs are derived from existing asset managers and private equity firms and are thus externally managed. This allows the BDC to benefit from the resources of the larger organization. There are some important variations, but external management agreements are typically structured with (1) a base management fee of 1.5% - 2.0% of gross assets, (2) an interest income incentive fee of 20% on net interest income above a set hurdle, and (3) a 20% incentive fee on realized gains net of realized and unrealized losses. While new entrants and the growth of the space have caused fees to compress over time, investors should be mindful of compensation structures as there tends to be little correlation to performance or shareholder returns. BDCs are typically financed through bank debt, by issuing bonds, or through government initiatives aimed at providing liquidity to small businesses (such as SBA facilities).

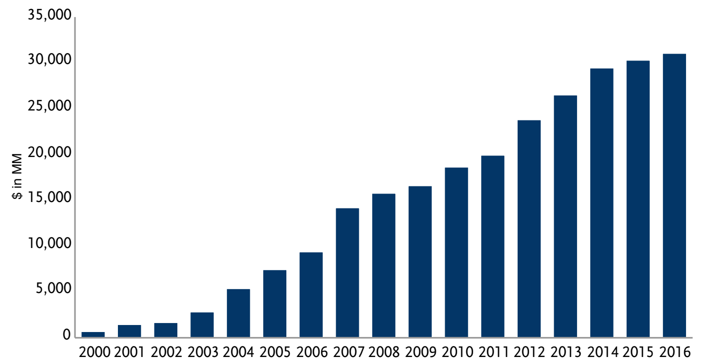
The U.S. middle market, defined as companies with annual revenues ranging from $10M to $1B, is very large – an estimated 200K companies generating one third of the country's GDP, and employing ~50M individuals. Sized at $5.9T, it would rank as the world's third largest economy (behind China and ahead of Japan). Middle market companies have historically fulfilled the bulk of their financing needs from traditional banks. However, regulations resulting from the financial crisis imposed steep capital charges on non-liquid assets and have made middle-market lending uneconomical for banks. The BDC industry and others have filled the void – the BDC sector has grown ~20-fold over the past 15 years to over $80B in assets held by the publicly listed firms. Despite this explosion, BDC investments account for only ~10% of the entire leveraged loan market, so the runway for additional growth remains long.

BDC Capital Raised



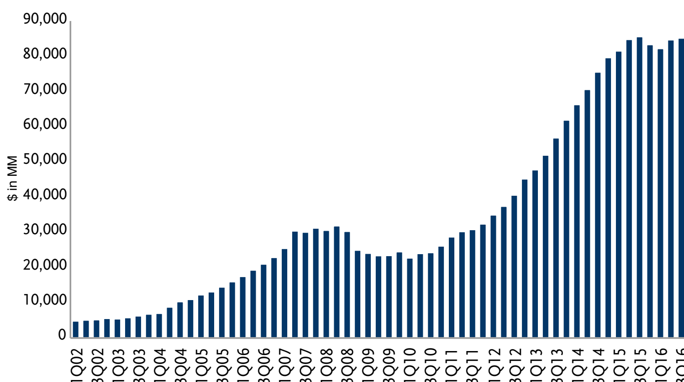
Source: Wells Fargo company reports, Wells Fargo Securities, LLC

BDC Cumulative Capital Raised



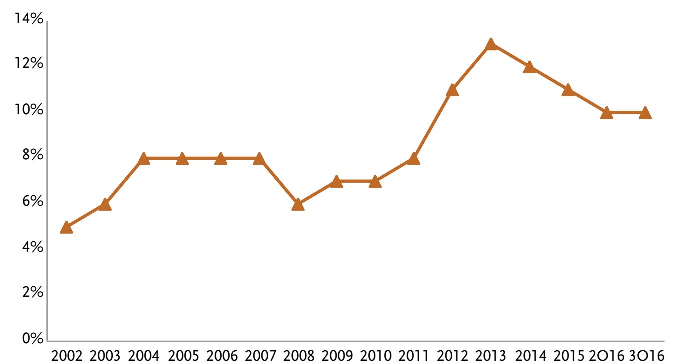
Source: Wells Fargo company reports, Wells Fargo Securities, LLC

Publicly Traded BDC Asset Growth



Source: Wells Fargo company reports, SNL, Wells Fargo Securities, LLC

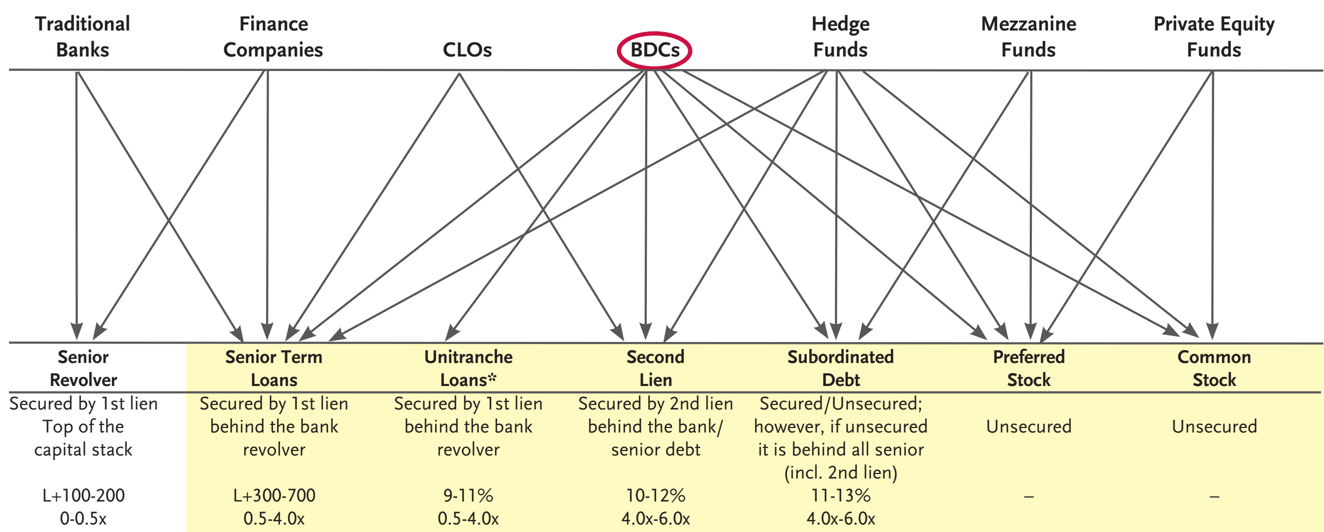
BDC Investments Relative to the Entire Leveraged Loan Market at Par



Source: Wells Fargo company reports, S&P LCD, Wells Fargo Securities, LLC estimates

Unlike traditional banks, BDCs have the ability to invest anywhere in a company's capital structure, including senior secured, second lien, and unitranche (a combination of senior/subordinated with a blended interest rate). BDCs may also hold equity positions (which often result from warrants attached to debt financing). Pricing is generally based on LIBOR plus a spread – ranging from 100 to 1300 bps – which is a function of the borrowing company's financial strength and the level of security behind the loan. As these loans are variable rate, BDCs tend to benefit in rising interest rate environments. Many BDCs are able to achieve ~9% yields from lending, which compares favorably to a cost of debt of ~3% (typically financed through bank debt, bonds, or government initiatives such as SBA facilities). Through the use of modest leverage, it is easy to see how the space can provide investors with an ~9% dividend yield even after management fees. The wildcard with regard to value creation or destruction ends up being loan performance, which is a function of underwriting skill. Although there are outliers, BDCs have historically outperformed the best loan mutual funds.

BDC Investment Spectra



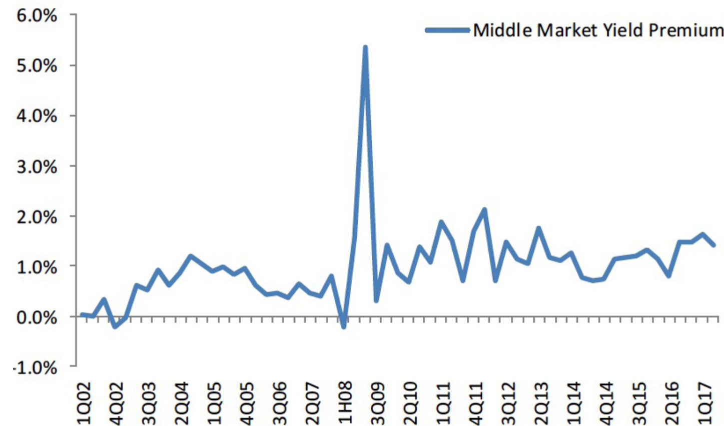
	Senior Revolver	Senior Term Loans	Unitranche Loans*	Second Lien	Subordinated Debt	Preferred Stock	Common Stock
Security	Secured by 1st lien Top of the capital stack	Secured by 1st lien behind the bank revolver	Secured by 1st lien behind the bank revolver	Secured by 2nd lien behind the bank/ senior debt	Secured/Unsecured; however, if unsecured it is behind all senior (incl. 2nd lien)	Unsecured	Unsecured
Coupon	L+100-200	L+300-700	9-11%	10-12%	11-13%	–	–
Leverage**	0-0.5x	0.5-4.0x	0.5-4.0x	4.0x-6.0x	4.0x-6.0x		

Source: Wells Fargo Securities, LLC

So what are the primary drivers of BDC stock performance? In the short run, where we are in a credit cycle matters a great deal. As the economy passes a peak, loan originations decline and existing assets weaken, which leads to increases in markdowns and defaults. Conversely, as the economy passes a trough and visibility into fundamentals begins to improve, it becomes a good time to originate loans and asset performance tends to be strong. Yet, while the macroeconomic backdrop is important, what matters even more in the long run is the skill and discipline of underwriting at each BDC, as we alluded to above. Well managed BDCs typically have dedicated teams focused on niche sectors of the economy. Often, there is a structural advantage or unaddressed market where long term relationships with sponsors or managers within an industry, coupled with the lack of alternatives from banks or similar lenders allows the BDC to originate favorable terms that would not be possible in more liquid markets. Through an entire business cycle, the best managers tend to significantly outperform other asset classes with similar risk characteristics.

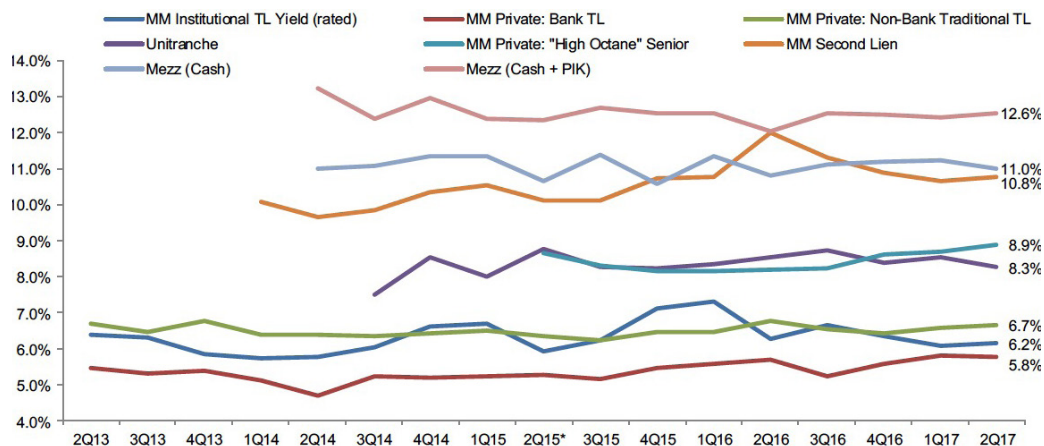
Despite a marked increase in the number of BDCs resulting in competitive headwinds, middle-market lending today still offers an attractive return relative to the larger corporate loan market.

Middle Market Spread Premium to Large Cap Loans (as of June 30, 2017)



Source: Wells Fargo Securities, LLC

Quarterly Middle Market Yields Across the Capital Structure (as of June 30, 2017)



Source: Wells Fargo Securities, LLC

Pockets of opportunity present themselves for private credit managers that are nimble across the capital structure. Even against a backdrop of spread tightening in the broader markets, certain segments continue to present opportunities for compelling returns. For example, while rated middle market institutional yields have declined in recent quarters, "high octane" (wide margin) private middle market yields have increased.

BDCs that invest across the capital stack within their strategy can benefit in the current environment and allocate to structures with the most attractive risk-adjusted return potential (with yield of course only reflecting one component of the risk/reward equation).

The relevant valuation metrics for BDCs are the Dividend Yield (DY) and the Price to Book Value (P/B), each adjusted for the level of coverage and the risk of the loans that they hold. Today, BDCs range in DY from ~6% to 12% or higher, and in P/B from ~0.6x for companies with obvious credit issues or poor managerial track records to ~1.4x for companies with deep origination pipelines and demonstrated underwriting expertise. BDCs that benefit from premium valuations are those led by credit managers that have

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been able to create value throughout a full business cycle. The best managers in the space have been able to post negative loss rates since inception – meaning that historically, their gains on investment have surpassed their losses in aggregate. Poor credit managers have annualized loss rates that approach 5% of their total portfolio value and can destroy capital even during times of economic expansion.

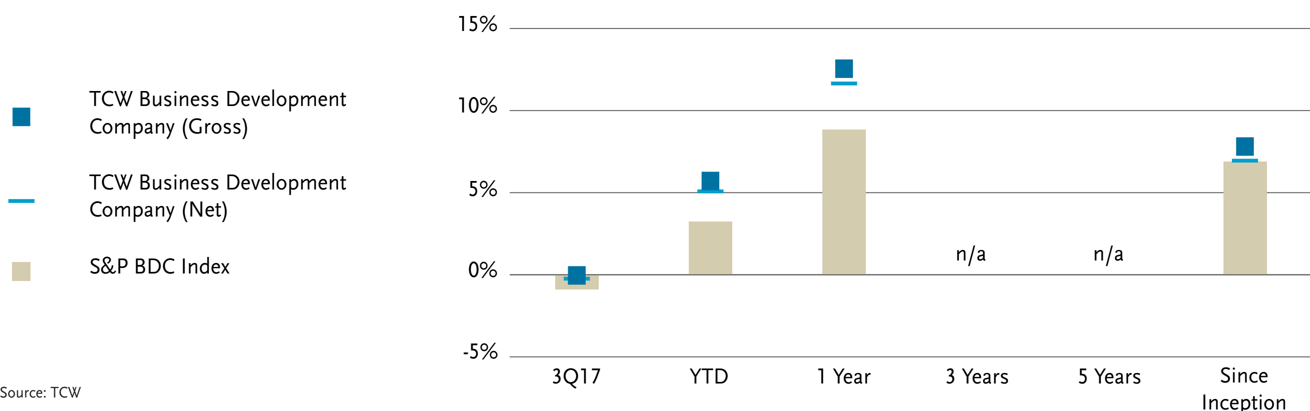
Despite the superior risk-adjusted performance of the top names in the sector, the BDC space as a whole has still not gained widespread acceptance with institutional investors (~40% versus. ~80% institutional ownership in the REIT space). Part of the problem is that BDCs are Registered Investment Companies (RICs), and are thus governed by the Investment Act of 1940 (like mutual funds). As a result, mutual funds holding BDCs are severely limited in their ownership and must report the BDC's pro-rata expenses in addition to their own in calculating expense ratios. The SEC is currently evaluating potential solutions.

Another issue is that a cursory glance at investments held by a given BDC could reveal holdings that would seem risky or outright speculative. For example, it is not uncommon to see a BDC lending to a troubled or bankrupt company. The key is to unveil and understand the specific structure of each debt instrument and the covenants used by the BDC as protection. What may at first glance appear to be a risky loan can actually be well-collateralized upon deeper analysis; the BDC's investment would remain sound under most realistic scenarios. By trafficking in small and under-covered niches, many BDCs are able to find exceptional risk adjusted return potential that is largely unparalleled elsewhere in the public markets.

In conclusion, we believe that low leverage and the tax-advantaged status of the BDC model allow for outsized risk-adjusted returns to investors, as long as the model is managed prudently. Well-managed BDCs allow for strong levels of current income – currently over 8% for many high-quality names – with the prospect of capital appreciation over an entire business cycle, and without exposing investors to high levels of leverage. Income-oriented investors would be well-served to familiarize themselves with the space and explore BDC-focused funds with strong long-term track records of performance. Since there are only a few investment firms with the required breadth of expertise across both credit and equity analysis to dissect winners from losers in the BDC space, we believe that there is an opportunity for dedicated analysts to add substantial value in the sector. ■

TCW Business Development Company Performance as of September 30, 2017

			Annualized			
	3Q17	YTD	1 Year	3 Years	5 Years	Since Inception 4/1/15
TCW Business Development Company (Gross)	**-0.04%**	**5.71%**	**12.55%**	**n/a**	**n/a**	**7.81%**
TCW Business Development Company (Net)	**-0.24**	**5.08**	**11.65**	**n/a**	**n/a**	**6.95**
S&P BDC Index	-0.91	3.25	8.84	n/a	n/a	6.89
Under/Outperformance (Gross)	*87 bps*	*246 bps*	*371 bps*	*n/a*	*n/a*	*92 bps*



Source: TCW

Please see additional performance disclosure on the last page. Past performance is no guarantee of future results.

TCW Business Development Company Performance as of September 30, 2017

	TCW BDC Equities	S&P BDC Index	Relative Performance
Apr-15	1.4%	1.6%	-0.2%
May-15	-0.9%	-1.4%	0.5%
Jun-15	-2.3%	-3.1%	0.9%
Jul-15	-2.4%	-2.2%	-0.2%
Aug-15	-0.3%	0.2%	-0.5%
Sep-15	-9.3%	-7.1%	-2.2%
Oct-15	4.7%	4.3%	0.4%
Nov-15	8.3%	7.8%	0.5%
Dec-15	-5.5%	-7.2%	1.7%
Jan-16	-5.2%	-6.3%	1.1%
Feb-16	1.8%	2.9%	-1.1%
Mar-16	6.4%	8.2%	-1.8%
Apr-16	1.4%	2.1%	-0.7%
May-16	0.1%	-1.2%	1.4%
Jun-16	3.2%	3.1%	0.0%
Jul-16	4.8%	5.7%	-0.9%
Aug-16	3.8%	4.3%	-0.5%
Sep-16	-1.2%	-1.6%	0.4%
Oct-16	-1.3%	-1.3%	0.0%
Nov-16	5.2%	3.9%	1.3%
Dec-16	2.6%	2.7%	-0.2%
Jan-17	1.6%	1.1%	0.5%
Feb-17	4.4%	4.7%	-0.3%
Mar-17	2.4%	1.2%	1.3%
Apr-17	1.4%	1.3%	0.1%
May-17	-4.7%	-5.8%	1.1%
Jun-17	0.7%	1.9%	-1.2%
Jul-17	0.2%	0.7%	-0.5%
Aug-17	-4.0%	-5.7%	1.6%
Sep-17	4.0%	4.3%	-0.3%
Since Inception (Ann.)	**7.8%**	**6.9%**	**0.9%**
Std. Dev. (Ann.)	13.6%	14.6%	
Sharpe Ratio	**0.57**	**0.47**	

	1-Year		Since Inception	
	TCW BDC Equities		TCW BDC Equities	
	(Gross)	(Net)	(Gross)	(Net)
Tracking Error	3.02%	3.02%	3.36%	3.36%
Cash-Adj. Alpha	4.42%	3.58%	1.41%	0.59%
Cash-Adj. Beta	0.87	0.87	0.91	0.91
Upside Capture	102.70%	99.59%	92.00%	89.55%
Downside Capture	79.54%	81.01%	88.38%	89.79%

Source: TCW

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Dr. Brivanlou heads TCW's High Income Equities group and is the Lead Portfolio Manager for the TCW High Income Equities and TCW Global REITs funds. He joined TCW in 2006 as an Analyst in the Equity Research group. His research coverage has spanned the real estate, insurance, business services, transportation, and consumer staples sectors. Prior to TCW, he developed and tested quantitative models aimed at predicting the sizes of catalyst "events" using option pricing for Kayne Anderson, a hedge fund in Century City. Dr. Brivanlou was a Howard Hughes post-doctoral fellow in Molecular Neurobiology at the Salk Institute in La Jolla. He holds a BS in Physics from Massachusetts Institute of Technology (MIT), a PhD in Neuroscience from Harvard University, and an MBA in Finance and Strategy from the UCLA Anderson School of Management.

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Mr. Tawinganone joined TCW's High Income Equities group as a generalist analyst in 2014 bringing over 10 years of investment management experience. Prior to joining TCW, Mr. Tawinganone was a Portfolio Manager and Senior Research Associate at Aria Partners where since 2004 he served in various functions including equity research, valuation consulting, and portfolio management. From 1999 to 2004, he was employed at Deloitte and Touche, LLP as a manager in the Assurance and Advisory division, serving clients in the financial services industry. Mr. Tawinganone is an inactive Certified Public Accountant in the state of California, a CFA charterholder, and a member of the Los Angeles Society of Financial Analysts. Mr. Tawinganone graduated with honors from Loyola Marymount University with a degree in Accounting and received an MBA with honors from the UCLA Anderson School of Management.

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