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Research Studies and Opinions

Pension Funds and BDCs: Why Portfolio Managers Should Consider Them

A Q&A

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Question: Why should pension funds consider investing in a BDC?

It gives them access to an asset class, which is primarily senior, second lien, mezzanine and unitranche lending to smaller middle-market companies in a liquid, publically traded security. It is analogous to investing in real estate through a REIT.

If you want to get access to that asset class without buying a BDC you would need to invest in private funds to get there, and they would not be liquid. There would also be an administrative burden associated with that. It would be much like pension fund real estate investing was in the late '80s and early '90s. Pension funds invested in a lot of real estate funds and then when the real estate market turned down they were stuck. They couldn't get out. Most of the investment vehicles were private. An evolution occurred from the early '90s to today where pension funds largely transformed their real estate investment programs from investing in private funds to investing in publicly traded real estate investment trusts. This allows them to allocate real estate dynamically by buying and selling without all the administrative overlay and illiquidity of private funds. A similar opportunity is available for investing in loans to smaller middle-market companies through BDCs. The asset class is very interesting because it pays a relatively higher rate of interest with relatively low risk characteristics. The risk-adjusted return is higher than it is for some of the larger, more public debt asset classes.

Question: What slice of the middle market do BDCs cover?

Generally speaking, the smaller end -- companies with $2 million to $3 million of EBITDA up to $25 million to $30 million of EBITDA -- is probably where most BDC money is invested. Some larger BDCs are funding bigger companies, from $30 million up to $100 million in EBITDA, but generally speaking, as you get to the high end of that range, those companies have broader access to public debt markets and the like. Generally, companies below $30 million in EBITDA don't have access to public markets. They need to borrow privately, and private borrowing is generally through BDCs, private debt funds and banks. As a result of that lack of access to public markets, there is a liquidity premium, so BDCs generally charge and get higher rates of return off of that lending than would be possible if the companies were larger.

Question: What kind of portfolio should think about a BDC investment?

Anybody who has an income-oriented portfolio. Such portfolios often have everything from money market securities, treasuries, high-grade corporate bonds, below-investment-grade corporate bonds, bank debt, syndicated bank debt, CLOs, etc. It makes sense that one would want to have an asset-class exposure to smaller middle-market companies, and the BDC is an access point to that asset class.

Question: What should be the size of an investment, given the capitalization of the field?

That would depend on the institutional investor. Institutions generally don't want to own much more than five percent of a company -- 10 percent would be a high-level of ownership in a given company. Since the total BDC industry capitalization approaches $57 billion, $2.5 billion to $5 billion should be the range of an institution's total investment.

Question: What is the rate of return of BDCs compared to REITs?

One set of BDCs yield in the 7 percent annual rate range. Some are ranging up to 12-13 percent. So anywhere between 7-13 percent is probably a good range of annual yields in the BDC industry.

As for the REIT industry, the current MSCI US REIT Index of Total Returns shows REITS producing an average annual return of 3.03 percent compounded.

Question: What is the liquidity of BDCs compared to loan portfolios?

It depends on the BDC, its size and market capitalization and trading volume. Technically, most BDCs are publically traded. (There are some private BDCs.) The underlying loans that BDCs make are private transactions. They're negotiated. There is legal documentation. There is confidence that comes from due diligence in the middle-market company. There are business plans to review. There are confidentiality agreements. It's an involved process to make one of these loans that requires highly paid professionals, competition, custom negotiation, due diligence and much more. It's expensive to buy and sell these loans and do a proper job. If you invest in a BDC, you get the result of all that in a clean dividend, paid monthly or quarterly, and you don't have to get into the complexities of management. The BDC is your investment manager. Much like REITs do, the BDC takes an illiquid asset class and makes it liquid. That's the beauty of what it does.

Question: How safe are BDCs for pension funds?

There are a couple of ways to look at BDCs on safety. One statistic that is often cited is that no BDC has ever failed to repay any debt in the history of BDCs. Admittedly, if you buy a BDC's stock you're buying equity, and you can lose money in the equity. But, no BDC has gone bankrupt. In certain extreme cases, they've defaulted on debt but they haven't failed to repay 100 cents on the dollar of all the money that has ever been borrowed by BDCs. So that's a measure of the credit record of the industry.

Now, it's hard to generalize on a stock basis because BDCs are going up and down, but generally speaking, they are quite stable. They went through the downturn in 2008-2009 and a few of the BDCs changed hands, but all of them made it through and have thrived. They're very durable. Part of the reason that they are safe and hardy is that there is a leverage governor. You can't borrow more than 1:1 debt to equity. That limitation on leverage enhances the safety of the asset class.

Question: How many kinds of BDCs are there?

There are BDCs that invest in loans. There are some that invest principally in equities. There are a few that are private equity oriented. There are some that specialize in technology; they leverage certain technology companies that, in and of themselves, don't have standard credit characteristics. Then, there are what are called private BDCs, which are quasi-private. They're registered with the SEC, but they don't trade on an exchange.

Question: What are the critical points a pension fund manager should know about BDCs as an investment vehicle?

One concern some pension fund managers might have is the fee structure, which is similar to investing in an alternative asset class, like a hedge fund. When a portfolio manager makes an investment, he should look at net returns, not gross pre-fee returns. Net returns in the BDC industry are 7-13 percent cash on cash, which are highly attractive in the alternative asset class. A BDC has a fee structure that is higher than would be charged by an asset manager investing in more liquid securities, but the reason for that fee structure is because the underlying securities are not liquid or simple to invest in. They are all fully underwritten investments in smaller businesses that aren't public. They don't have SEC reporting, and there is a lot of work and judgment required to make a loan. As a result of this, BDCs have characteristics of alternative asset managers, yet they are publicly traded stocks and so they may not currently fit neatly in the asset manager categories of institutions.

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