WELLS FARGO Advisors

Guide to investing in business development companies (BDCs)

Summary

Business development companies (BDCs) are specialty finance companies that facilitate investment in the private and public businesses of the small- and middle-market segment of the economy. The majority of BDC earnings must be paid out to shareholders in the form of dividends. As such, BDCs often have dividend yields which are well above the yields of other dividend-paying common stocks, the interest rates of Treasury notes and bonds, or other income-oriented financial instruments. BDCs have a variety of risks, are not appropriate for all investors, and should not be purchased on the basis of yield alone.

Overview of BDCs

BDCs are specialty finance companies regulated under the Investment Company Act of 1940 and were created to facilitate investment in the private and public businesses of the small- and middle-market segment of the economy. Among other restrictions, BDCs are required to invest 70% of their assets in qualifying assets — generally securities of private companies or thinly traded public companies with a market capitalization of less than $250 million. Additionally, BDCs must operate under a maximum leverage (total debt to total equity) ratio of 2:1x.

In addition to being regulated as a BDC, many companies also choose to qualify as a regulated investment company (RIC) for federal income tax purposes. For a company to maintain its status as an RIC, it must derive a minimum of 90% of its income from sources that include interest, dividends, and realized capital gains. It also must pay out at least 90% of its annual investment company taxable income as dividends. To avoid paying an additional excise tax, it must distribute 98% of its annual investment income.

The BDC structure allows investors to participate in the income and appreciation potential of loans made to privately held, middle-market companies while maintaining the liquidity of a publicly-traded equity. Since the majority of earnings must be paid out to shareholders in the form of dividends, BDCs often have dividend yields well above those of other dividend-paying common stocks, the interest rates of Treasury notes and bonds, and the yields of other income-oriented financial instruments. Investors should not look exclusively at the dividend yield of a BDC to judge its investment appeal.

BDCs do not generate unrelated business taxable income (UBTI). Instead, BDCs act as a blocker to UBTI and are exempt, thus they may be appropriate for 401(k) plans and individual retirement accounts (or IRAs).

We have a responsibility to consider reasonably available alternatives in making a recommendation. We do not need to evaluate every possible alternative either within our products or outside the firm in making a recommendation. We are not required to offer the “best” or lowest cost product. While cost is a factor that we take into consideration in making a recommendation, it is not the only factor.

You should consider factors such as those below prior to accepting a recommendation:

- The potential risks, rewards, and costs in purchasing and in the future selling of a security.
- Your age, other investments, financial
- The security's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions.
- For complex products, you should consider whether less complex or costly products achieve the same objectives.

By accepting a recommendation, you acknowledge that you have considered the above factors to your satisfaction, situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.

Features of BDCs

The target market for BDCs is the middle-market borrower. Specifically, BDCs specialize in realizing financing opportunities that arise due to acquisitions or leveraged buyouts, with a primary focus on small- and middle-market firms that typically generate $3 million – $50 million of annual EBITDA (earnings before interest, taxes, depreciation, and amortization). EBITDA is often used by investors and creditors as a measure of a company's operating cash flow. BDCs may invest across the capital structure of these small- and medium-sized enterprises, and they may shift investment strategy depending on their assessment of the relative attractiveness of investment opportunities. Most BDCs extend financing in the form of debt but on occasion will take an equity position in a prospective company. BDCs also offer managerial assistance to their portfolio companies, typically for a fee.

While all BDCs strive to generate income and capital gains through debt and equity investments, their individual investing styles may differ considerably. Some BDCs may focus their investments in a few industries, such as software, healthcare, or business services, which are thought of as having non-cyclical, defensive growth qualities, while others may pursue investments in a broader, more diverse set of industries. Some may invest primarily in the upper part of a company's capital structure, such as in first lien senior secured loans, while others may be open to preferred or common equity investments as well. Some BDCs focus on originating loans with companies that are mature middle-market borrowers while others may target companies earlier in their corporate life cycle, possibly the venture capital stage of development.

The returns and dividends generated by a BDC are dependent on the ability of the management to successfully find and originate new assets. As part of its compensation, the manager or management of the BDC takes a fee (likely 1% – 2% of assets per year) which is often applied to all assets, even though a significant portion of the assets may still be in cash. It is important to note that after a BDC goes public, it may raise additional equity in a series of follow-on equity offerings. Another important note, dividends may be nonexistent or below target expectations until the proceeds of the equity offering are invested in cash flow-producing assets.

Because the structure requires nearly all earnings to be paid out to shareholders, we think that among the more sensible dividend frameworks for BDCs is a base dividend that can be met with ongoing earnings power, with supplemental dividends declared to satisfy regulatory requirements, while preserving net asset value (NAV) per share. This approach is often appreciated by investors. Again, we believe investors should not look exclusively at the dividend yield of a BDC to judge its investment appeal.

Some investors believe that BDC earnings benefit from periods of rising interest rates given that their portfolios often consist mostly of floating-rate loans. That theory does not always work in practice. Much depends on the interaction of many variables, including the mix of the portfolio (such as fixed-versus floating-rate assets, leverage, and funding costs). For instance, the portfolio mix can change, altering the sensitivity of earnings to higher rates (which may not be much to start with in the view of some BDC managements). BDCs also operate with lower leverage than some other financials. Some BDCs make loans with interest rate floors such that earnings may not rise with the initial rate hikes. Earnings for the BDC may even decline as interest expenses increase with the rate hikes until the floor rate is met. Also, the benefits of better new-issue yields may be offset by spread compression. Lastly, fee or other income items that ultimately factor into earnings may be completely independent of moves in interest rates.

Potential risks related to BDCs

All investments are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors due to numerous factors some of which may be unpredictable. Be sure you understand and are able to bear the associated market, liquidity, credit, yield fluctuation and other risks involved in an investment in a particular strategy.

As investment vehicles, BDCs/RICs come with inherent qualities and risks which are usually outlined in the prospectus. These securities are not appropriate for all investors and should not be purchased on the basis of yield alone. The market price of these securities may decline. We have listed several of the risks associated with BDCs/RICs below. This list is not exhaustive, and there are likely other risks that may be significant for investors considering BDCs.

Dividends

Dividends are not guaranteed and may be subject to change, including reduction or elimination. Also, a portion of dividends may be paid in shares of stock rather than in cash.

Leverage

BDCs are companies which employ financial leverage. By statute and with the approval of shareholders, a BDC may borrow up to two dollars for investment purposes for every one dollar of investor equity. To put it another way, the debt-to-equity ratio of the company must be less than 2:1. Additionally, portfolio companies of the BDC are often highly leveraged as well.

Lending and credit

BDC/RIC investments may be mezzanine loans that are subordinated to senior debt holders. In the event that the senior debt holders are not paid off, holders of mezzanine (subordinated) debt risk default. Furthermore, the loans made by the BDC could be based on cash flow and may or may not have tangible collateral backing them. Due to their size, the assets of BDCs/RICs are rarely rated by a credit rating agency. However, it should be assumed that these assets are below investment grade and share many of the risks inherent in high-yield bonds, including a greater risk of loss of principal and interest and default as compared to higher-rated bonds.

Rising interest rates

Higher interest rates could affect the valuations of BDCs/RICs given their historically high dividend yields. Also, rising interest rates may pressure the financial results of portfolio companies, leading to higher nonaccruals.

Economic contraction and market stress

Recessions, economic downturns, or market stress may hurt portfolio companies, which may then be unable to make principal and interest payments. Loans by the BDC may become past-due loans and nonperforming assets during a recession. If there is an increase in delinquencies and nonperforming assets, it may result in realized losses, and dividends for BDCs/RICs could decline. Financial sponsors may be unwilling or unable to provide financial support to portfolio companies (their investments) during periods of economic or market stress.

Funding risk

BDCs are dependent on banks for a majority of their debt-funding needs, and these are mainly provided through three-year revolving credit facilities.

Dependency on equity markets to support growth

Because of the 98% distribution requirement on operating earnings, BDCs/RICs are not able to retain income to grow. As such, they require continual access to the capital markets to support the growth of portfolios. The inability to access the equity markets, increased volatility in the capital markets, or the withdrawal of market liquidity would severely limit the growth opportunities for BDCs/RICs. During the market stress in the spring of 2020 precipitated by COVID-19, some BDCs sought liquidity and raised equity at levels below NAV.

To learn more about BDCs, contact your financial advisor or visit the following websites:

Wells Fargo Advisors
wellsfargoadvisors.com

U.S. Securities and Exchange Commission
sec.gov

Securities Industry and Financial Markets Association
sifma.org

Financial Industry Regulatory Authority
finra.org

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Competition

The perception of attractive lending opportunities may lead to increased competition from alternative asset managers, private credit funds, banks, and other commercial finance companies. Importantly, with regulations now permitting a debt-to-equity ratio of 2:1, more capacity is likely to enter the market and may pressure investment returns. Increased competition may weaken underwriting conditions, pressure asset yields, and prompt some BDC managers to pursue credits with a higher risk profile. Also, some BDCs — such as those associated with established alternative asset managers — may have access to greater sourcing, financial, and analytical resources than do smaller managers.

Potentially higher volatility

The investment portfolios of BDCs/RICs can be more concentrated than other finance companies. Therefore, the financial results of BDCs/RICs could be more volatile and less insulated to any one particular credit. This volatility could be exacerbated by the fact that BDCs/RICs do not accumulate loan loss reserves to buffer their operations from potential loan losses — instead, unrealized and realized gains and losses flow directly to earnings.

Limited transparency

Because the majority of portfolio companies in a BDC/RIC portfolio are private, there is an inherent lack of publicly available data to independently assess management's carrying values of portfolio companies. Portfolio holdings are marked to market[1] by the BDC's/RIC's management, which has the potential to be viewed (correctly or incorrectly) as a conflict of interest.

Management

Some BDCs are advised by an external investment management team. The BDC's board of directors may act in ways favoring the external manager, which may not be in the best interests of the broader BDC shareholder base. Also, the departure of key personnel from the investment manager, whether external or not, may have a negative effect on the operations of the BDC. Other conflicts of interest may exist for the investment manager too — for example, the presence of other credit funds advised by the manager.

How are your financial advisor and Wells Fargo Advisors compensated on transactions?

For helping you invest in BDCs, Wells Fargo Advisors and your financial advisor are compensated in ways that vary depending on the selected investment. Your financial advisor will receive compensation in the form of a commission from most transactions.

For most purchases, a financial advisor's compensation is based on the dollar amount purchased or sold in the BDC transaction. In certain fee-based accounts, a financial advisor's compensation is based on a percentage of assets in the account. The compensation formula that determines the amount of payment to your financial advisor is generally the same for all BDCs.

In addition to receiving compensation, your financial advisor may receive internal credits in the syndicate allocation process for sales in BDCs and other products. Financial advisors may receive allocations of new syndicate deals based on the number of internal credits accumulated. For example, a financial advisor accumulating a large number of internal credits based on past sales of those transactions may receive a greater allocation of a new syndicate issue than a financial advisor with fewer credits.

Within the division that operates in Wells Fargo financial centers and some Wells Fargo branches, a licensed banker may refer you to a financial advisor, as they generally work as a team. In this case, the licensed banker will be compensated through a referral arrangement with the financial advisor.

Wells Fargo Securities, LLC (WFS), may receive compensation for making a market and keeping an inventory in the common stock of select BDCs. WFS or its affiliates may receive compensation for investment banking services of select BDCs.

1. Recording the price or value of a security to reflect its current market value rather than its historical cost.