Read the transcript from the panel session discussion titled: "Keys to Analyzing the Risk & Opportunities in BDCs"

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Nick Marshi, author for the BDC Reporter, Barry Sloane, President and CEO of Newtek Business Services, Bryce Rowe, Managing Director of BDC Research at National Securities, Kelly Thompson, Founder and Editor of Direct Lending Deals, and John Cole Scott, CIO at CEF Advisors and Executive Chairman at AICA, were panelists at the AICA Boot Camp and Round Table held on November 6th in New York City. The moderator of the panel was Harry Pangas, Partner at Dechert LLP. Read the transcript from the discussion below to hear the insight from the panelists.


Harry Pangas


Nick Marshi


Barry Sloane


Kelly Thompson


John Cole Scott

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Harry Pangas: My name is Harry Pangas, I'm a partner at Dechert LLP, a law firm in Washington D.C. I focus my practice on representing BDCs, have done so for about 20 years, and so happy to moderate this panel. So before we get started, I'd like to ask each of the panelists to take a couple of minutes and tell us about their experience with either BDCs or private credit. Then we'll introduce the panel, we'll go over a couple of housekeeping rules and then we'll jump in. So Nick, do you want to start us off?

Nick Marshi: Yes. Is that working? My background is in lending and private equity, but I found my way to BDCs about 15 years ago when it was just a nation industry. The last ten years I both ran a fund that invested in BDCs equity and debt, but also write the *BDC Reporter*, which is an online publication which discusses every day news views and developments where the BDCs are concerned.

Harry Pangus: Bryce?

Bryce Rowe: Hi, I'm Bryce Rowe, I'm an equity research analyst for National Securities. I've been there for about three months. But I've covered small cap banks in the BDC sector for about 20 years, most of that time was at Robert W. Baird in Milwaukee, and moved to National here recently. National is a full service brokerage firm, about 750 retail advisors throughout the country managing about 13 billion dollars.

Kelly Thompson: Hi there, my name is Kelly Thompson and I'm the founder and editor of *Direct Lending Deals*, which is a publication that covers direct lending. And I know I get zero points for creativity on that name, but it does draw people in. I just launched that in September, so we're new. Before that I was with a start-up called *LevFin Insights*, where I covered middle market lending. And before that I was with S&P LCD for about 15 years, where I covered mostly middle market from 2003 onward.

John Cole Scott: Again, John Cole Scott. I might assume everyone knows me and my for profit, but we're another really creatively named business; Closed-End Fund Advisors. The only difference is we bought it, we didn't create it. Our main business is separate account work for investors and advisors, mostly income and risk based, so some very tax thoughtful stuff. One of our favorite models is a 6.1 after-tax, after-fee yield. You can't guarantee performance of course. And then we also use BDCs as you know, heavily in our practice. Learned about them in 2014 and how we beat the BDC UTI with smart trusts in Parsippany, New Jersey; series 17 launches on Friday. And I just love the uniqueness of the BDC structure. There's such manager uniqueness, and then the shareholder quality uniqueness. Where there might be 30 liquid funds, they're all very different with their own story. Versus the other traditional closed-end fund sectors. I just find, yes, there's differences but a lot more homogeny, and I just love the uniqueness of the wrapper.

Harry Pangus: Great, thanks everyone. So obviously we're going to be talking about the risks and opportunities of investing in a BDC, and we're going to be doing it from the investor perspective. And so I think if you have a question that fits into the conversation, please raise your hand. I find it's sometimes better to have a dialogue. If not, don't worry about it. If you're shy, we'll try to leave some time at the end for some questions. So this topic, we're going to really kind of do a quick intro to BDCs. I think you've heard a lot about them today, a lot of you are in this space and know them. But we understand that there's a diverse group of people in the audience. And then we're going to start doing a deeper dive into the structure. So with that, Bryce, I'd like you start. And maybe if you're speaking to an investor for the first time about BDCs, how do you explain it to them, the good, the bad, and the ugly?

Bryce Rowe: Sure, so I think the best way to think about a BDC is, a BDC is essentially a lender, different than a bank that uses deposits to fund that lending activity. BDCs will use equity and debt capital to fund those loans. Not all BDCs are a hundred percent debt capital. There's some BDCs that are heavier into equity investments than others, but I like to think about a BDC being the debt capital side of a private equity transaction. Most BDCs will work with private equity sponsors, and the private equity firms will provide the equity and the BDCs will come in and provide the debt capital alongside that equity. In terms of the good, BDCs provide nice yield. Typically you've got a dividend yield in the high single digits, or maybe in the low double digits. And then in terms of the bad and maybe the ugly, BDCs as a sector haven't really done a great job in preserving their book value or preserving their shareholder's capital. So I think you have to be really super conscious of those book value per share trends over time. I think it was mentioned the last panel that the good ones trade at a premium to book value, and the bad ones trade at a pretty big discount to book value. So that's the bad and the ugly combined.

Harry Pangus: I probably should have said the good, the good, the good. But none the less, thank you for that. So Nick, we're going to turn to you. Obviously you've been following the BDC industry. I would tell you all my clients, when you write an article about them, they read it and worry about what you're going to say about them. So you obviously have captured the minds of at least the managers in this space. So it would be helpful for you to provide an overview of the industry; number of BDCs, size of BDCs, etcetera.

Nick Marshi: Well, the industry is quite middle aged let's say, it started in 1980, but it didn't really start to get going until about 2003, so we're only talking about 16 years. And at the moment, based on advantage data, the total industry has a fair market value about 107 billion dollars. But what we're talking about are the public companies that make loans. Which eliminates the non-traded BDCs that make loans, but which are non-traded and are not on the public markets. And then there are some BDCs that are still involved in what the BDC structure began as, which is as venture capital companies. So the real BDC market that we're going to speak about today is about 66 billion. It involves 46 public companies, with the largest being Ares Capital. Which is way, way bigger by a factor of 30 or 40 times, than the smallest BDC. So the size of the BDCs, the businesses and the models that they're involved in, as John was saying, varies enormously.

Harry Pangus: Great. So just a follow-up question there. Obviously we've said BDCs focus on private credit. I have a number of clients coming to me and saying, "Well, why isn't there an equity only BDC?" My response is it's probably because investors go after the yield and you can't consistently provide that yield. But I don't know if any panelists have any thoughts on that. Bryce?

Bryce Rowe: Well, actually there used to be one; Capital Southwest, until they spun out into a credit strategy in 2015. They had deep concentrations within three or four different equity investments and they traded at a discount to NAV pretty consistently. There wasn't much liquidity involved with it. So I think that it has been traditionally a retail oriented product, and those retail investors are interested in yield, and consistent yield.

Harry Pangus: Great. So obviously we're talking about most BDCs, it's private credit. So Kelly, I'm going to ask you a question about private credit. And really, can you walk us through what BDCs provide investors, the ability to access that market? And maybe talk about other ways aside from the BDC, to access the private credit market.

Kelly Thompson: Sure. BDCs, I think they're one of really one of the only ways for a retail investor at the retail level to get into private credit. The other ways you could get into private credit, and when I mean private credit, I mean direct lending. Direct lending is a subset of private credit, which can mean lots of different things that they were talking about on the panel before us. It could be real estate, it could be alt assets, it could be special situations, all of that falls into private credit. What the BDCs really focus on is direct lending, and that's sort of the big market that's in the news a lot. Other ways to get into direct lending would be a middle market CLO, or you could go to a credit fund. But both of those are really geared toward institutional investors, and to get into direct lending from a retail perspective, I really can't think of another avenue other than BDCs or closed-end funds. The beauty of these, I think compared to the other vehicles, is that they print their schedule of investments every quarter, so you have an open book as to what they're investing in. You're not going to get that with the other two. The other thing is, is they're very liquid. So if you don't like where the managers are going with their strategy in direct lending or whatever, you can trade out of that pretty simply, rather than locking your money up for five or seven years, or whatever with other types of funds.

Harry Pangus: Okay, great. So let me just pick up on something Kelly said. She talked about the fact that BDCs publish their schedule of investments, we call it an SOI, and they list every investment. They list the nitty gritty about it. The name of the investment, the yield. Obviously BDC managers, a lot of our clients don't like it because they think that other managers look at it and try to go to that portfolio company and re-finance the debt. But that schedule is produced quarterly because the BDC regulations basically require BDCs to determine the fair value of their assets on a quarterly basis, and publish their NAV, their net asset value. So this is questions for you, John. Obviously we have a lot of folks here who invest in more traditional registered closed-end funds, and they're used to seeing more current information with respect to the NAV. Some registered closed-end funds produce it daily. So if you're speaking to a registered closed-end fund investor and they're now getting it four times a year, what do you say to them about that difference?

John Cole Scott: Well, I'll tell you, five and a half years ago, that was me. So when there were enough BDCs to have options, we added the coverage in our CEF Data dataset. And then I started to read people's work, like Nick Marshi, the *BDC Reporter* and "BDC Buzz" on *Seeking Alpha,* and start to learn the differences. I'd say the main differences are, if you heard earlier panels, they talked a lot about discounts and reversion to mean. And that in many cases, a wide discount can narrow and you make money on the alpha between NAV doing what NAV does, and a narrowing discount. And I'd say in my opinion, in a lot of our work for most BDCs, not in every case for anything of course, but a wide discount often in my opinion is future NAV write downs, poor governance, poor dividend coverage. People expecting a 30% dividend cut, so they're baking that into their analysis. And if you think about BDCs have traded well, at the end of the day, the yield if it's 7 or 14, and this is not perfect, but the liquid investors in a listed BDC are telling you how much risk they determine to get cash-flow from the company. I think that's a big piece. A lot of our really smart Data clients, one of them attended the BDC Roundtable with me this year, used to be a mortgage manager at Western, smart guy. He bought a lot of deeply discounted BDCs, and some of them we invest in and can make money in, but he made that mistake. And so I really think it's important, as I always tell an investor or a BDC manager, really you're running two things. You're lending money and getting paid back, that's the NAV, the direct lending. And then you're a steward of shareholder capital with a common equity base. You have to be a good CEO, a good fund sponsor, be fair and transparent to your investors, and then they'll trust you and give you that premium, and then you should trade better.

Harry Pangus: Okay, let's stick with the concept of NAV and fair value. So BDCs primarily invest in private credit, obviously there's not a market for that. You can't go look at a stock exchange and say, "This asset closed at Y." And so for the BDC industry, really I'll call it the Achilles heel, and I think they've done a great job of taking care of that issue, has been how do you determine the fair value of your assets on a quarterly basis? There's obviously a degree of subjectivity, and how do you get investors comfortable that managers aren't overvaluing the assets? And so this question is for Bryce and John, can you walk us through what BDCs do to deal with this particular issue from a governance standpoint and otherwise?

Bryce Rowe: Sure. So each BDC internally marks each asset to market through a fair value process each quarter. And then BDCs will hire a third party to value some number of the assets. Some BDCs value close to a hundred percent every quarter, some BDCs will value 20% of them every quarter, so it's going to vary by BDC. But they do have a thirty party come in to value those assets, and the board has to decide whether they go with that asset value or if there's a discrepancy.

John Cole Scott: I'd say that's part of where I really like the 40 Act wrapper over the BDC. Versus you imagine that lending happens in operating companies, not just in 40 Acts. I remember attending a pre-session for the Roundtable one year for BDCs, and it was an hour and 15 minutes from a valuation firm just on that one topic. And they went into all these inputs of secondary market for similar loans, "Look at the BDCs. Look at same company or different investments from the same company and how they're being marked by various BDCs." And all these inputs helping with a good NAV. I'd say the end of that hour and 15 minutes, they learned a lot, what data we should collect as a data provider. The basic answer was, trust the manager. Because in the 40 Act, the independent board and the valuation committee is a mechanism for transparency and the ability to be fair there. And then a quick order, you were right, 5:20 is the end. I talk until 5:30, so I'll be done at 5:20.

Harry Pangus: To bring that up in the middle, but no problem.

Kelly Thompson: Could I just add something really quick?

Harry Pangus: Sure, please.

Kelly Thompson: So BDCs have to invest 70% of their assets in small to middle market companies. Trying to put a value on those is incredibly difficult. The other 30%, let's say, are invested in syndicated loans. There's a secondary market for that stuff. Those are much easier to market than the 200 million loan you underwrote the for the company that has 50 million in EBITDA. So it's definitely more art than science in valuing those assets, but I would say that everybody across the street investing in direct lending is in the same boat. So they're incredibly difficult to value, and I know that that's one of the challenges. But having said that, they're all trying to do it. There's no one that's doing it any better than other. Well, I guess you could argue that there are, but it's very difficult to value those assets.

Bryce Rowe: Yeah, and I think BDCs are better off to be conservative. They get punished less by investors if they either put an investment on nonaccrual status before the other BDC that might own that same asset. Or they'll market lower, or as low as it really should be marked. And they're going to get some benefit from being conservative.

Harry Pangus: I guess just two points on something the panelists said. First off, when I started back in 2000 representing BDCs, it was not common to use an independent valuation firm. It was kind of the exception rather than rule. Back then there were probably six or eight BDCs, so there wasn't a whole lot. One BDC ran into trouble with a short seller, David Einhorn, and I think everyone learned the lesson that it's good to have an independent valuation firm touch your assets. Whether it's a hundred percent each quarter, or 25% each quarter, so that at the end of the year a hundred percent is touched. Because it really helps with investor confidence in the marks. It's also true with the SEC. And variably, if the SEC is asking about valuation and we proffer a valuation report, the issue goes away. So I think today I can't think of one BDC that does not use in some shape or form, valuation firms. The other thing to mention, and I think both panelists mentioned this, is that per the Investment Company Act of 1940; that's the statute that governs BDCs, the federal securities laws. That statute says the responsibly of determining the fair value of assets that's not quoted or there is no quoted market value, is the board. So the board every quarter takes this responsibility extremely serious, because really they're not overseeing this process, they are actually determining the value. So it's a very, very robust process for that reason. So we're going to turn to Bryce and Nick, and mention the investment company act of 1940. When you invest in a company, you need to understand the regulatory overlay, and there are a ton of regulatory overlays in the BDC space. So I'd like to ask you two guys to kind of talk about the more significant regulatory overlays. I know we've spoken about some of them today, but to hear from your perspective as well. I don't know if Nick, or someone wants to?

Nick Marshi: Well, I'm not a lawyer, so I don't want to misstate anything, but I think the most important one is the leverage ratio. The BDCs until recently were required, if they were going to get their nice tax benefit, not to leverage themselves more than 1:1. The Small Business Credit Availability Act came along, and now they're able to leverage themselves up to 2:1. And that as we'll discuss later, has changed the shape and the ambitions of the industry. And as Kelly was mentioning, 70% of their assets have to be in what you would expect them to be, private lending sort of loans. But then 30% basket of their assets can be in any sort of things. And it can be CLO equity, it can be in shipping as somebody was mentioning earlier, it can be loans in Lithuania as some BDCs have been involved in. And that gives them a huge area to differentiate themselves one from the other. So that's just some of the key rules.

Bryce Rowe: The one thing that I would add is that BDCs are required to pay out essentially all of their earnings, or at least 90% plus of their earnings as a distribution to shareholders. That means they cannot retain earnings or retain capital for future growth purposes, to grow their investment portfolio. If you think about who a BDC lends to, they're lending to non-investment grade companies in levered transactions. Some of those investments are going to go bad. And so those that have developed ways to offset those inevitable losses, are doing really well and trading above book value. And have access to capital markets, and access to equity capital for growth. So I think that's a really important point to think about, is that there's no ability to retain capital. And so those that can figure out a way to grow book value per share over time, have really, really done well.

Harry Pangus: Okay, yeah. I think you guys did a perfect job. The only thing I would supplement is the thing that we spend the most time on is affiliate transactions. So the Investment Company Act of 1940, unlike other statutes says you cannot do most transactions with an affiliate; so an investment advisor or a fund that you're investment advisor manages. There are certain exceptions obviously, and so we spend a lot of time with clients, dealing with that particular provision. But obviously that's a significant corporate governance benefit. So let's talk about leverage, do a little deeper dive. This is for Nick and Kelly. Obviously the legislation is one thing. The way the legislation worked was, BDCs had this ability to go from 1:1 debt to equity, to 2:1. They could either get the board to approve that. If the board approved that and you were publicly traded, it took effect one year from approval. If you went to stock holders and sought approval, it took effect the next day. And various BDCs used one or the other options, or some of them tried to go for two, "Let's get the board to approve it. Let's get stockholders to approve it," because it will accelerate that one year timeframe that I talked about. But the question for you guys is, it's one thing that the statute allows it, and it's another thing with respect to what the market reacts to it, how bankers react to it, how rating agencies react to it. So I'd love to get your perspectives on that point.

Kelly Thompson: You want me to answer? Okay. So they're able to go to 2:1 if they can get approval. So let's say they get that. Compared to the other vehicles that invest in direct lending, that's really not very much. Credit funds, private credit funds can get anywhere from one to three times leverage for their investments. Middle market CLOs, many times more leverage than a BDC. So you'll get hedge funds and banks, and what they had been leveraged at right before the credit crisis, was just crazy. I think looking at it from, what are your other options? The 2:1 ratio is really not that out of order or out of line, I don't think.

Harry Pangus: Nick, I don't know if you have anything?

Nick Marshi: Yeah, I spend a lot of time thinking about the leverage being both an investor and an author on the subject. Because I was around in 2008, 2009, and it wasn't a good time. And the BDCs had trouble when they were leveraged 0.7 times to one at the time. It's not only about the amount of the leverage, but the fact that if you break through whatever the threshold has been set when your assets drop during a recession. I think you mentioned this earlier, you are not allowed to pay out any dividends. And so if you're an investor and you suddenly have your dividends cut off in the middle of a recession because a BDCs assets drop, because they were very close to their debt to equity ratio, you're going to be very unhappy. And that happened to a lot of BDCs in the last recession, and it was the blight of the industry for a while. And as a result, rather than take advantage of all those wonderful lending opportunities, where now you could get huge spreads on loans to the people that still wanted to do LBOs, you were mostly trying to sell assets and get back to a state where you could pay out dividends again. So when the government changed the rules this time and made it even, you could borrow even more than before, the BDCs bless them, have learned a lot from the last time and they've all set themselves target leverages at varying degrees. Nobody is going to two times. Where before it was 1:1, there were BDCs at 0.95 times, and obviously it's an accident waiting to happen. This time, most of the better BDCs are targeting at a range to one to 1.25 times. And that seems to be much more reasonable and goes to show that they've learned from the lessons. But there will always be a few players who say, "No, we'll be fine," in order to get their earnings up, and might push it up. And we'll find out next time that things go wrong.

Harry Pangus: Okay, let's switch gears a little bit. So now we know about BDCs. We know about their regulatory structure, the good, the bad, the ugly. Let's talk about it from investor perspective. So question for you, John. Typical BDC investor, what are they in for? Is it dividend, capital appreciation, or what should they be in for given the structure of the vehicle?

John Cole Scott: Yeah. A lot of it has historically been the yield, because it's kind of a credit alternative. Say that whether it's an interval fund, or traditional closed-end fund, or BDC, are mindful of your investment principal to the future, keep producing that yield. But it does seem to be a yield story like the regular closed-end fund market and how they really think and analyze the funds. It doesn't quite interact with some of the traditional funds, but there are many times where people will just decide a certain fund should yield eight, nine, ten, and whatever the dividend does, it sets to that implied price to yield. Versus

I think a lot of us would say, "Well, what is their history in getting paid back? If they make an investment and lose money for shareholders, do they share in that pain or can they book an incentive fee?" Which some BDC regs allow for. So that's far more important. And the reason why I hope more institutional investors get interested in BDCs, is so they can actually analyze them better, is they just focus on the yield still, it's so many structures.

Harry Pangus: Okay. So follow-up question to that, and I think you mentioned this earlier John. A lot of BDCs trade at a discount to their NAV, and so you would assume that you can buy the stock at five, and if the NAV's at ten, some day or other, the stock's going to trade at ten and there's a nice five dollar gain in your pocket. So this question is for whoever wants to answer it. How do you evaluate the ability to capture that spread? Is it possible? And what do investors need to think about when choosing a BDC to gain that?

John Cole Scott: I'll speak quickly and want the other folks chime in. I would say to have a discounted BDC be of interest to us, we have to understand the story, the thesis. And so I don't know if you know about our *NAVigator* podcast, the sixth one was last week with Saratoga. Which Steve here's on the board of, the current board director. And they were a chance for us to learn about a turnaround story. They took over a broken BDC and had the resources, and the mechanisms, and the good cheap leverage, and the tenacity to turn that fund around. It trades above book, eight, nine premium right now. That's not every BDC, and it's not the biggest BDC, but it's a story of a manager committed structure, provisions that were fair, leveraging their resources, and they got there but it wasn't a simple two quarter fix. I think Nick can chime in, it's a five year process to turn around any BDC.

Harry Pangus: So Nick, Bryce, any thoughts on that question?

Nick Marshi: I think investors look at discount to book value because it's easy to do, but I think more sophisticated investors, and there are plenty out there, let's not underestimate this market. Both amongst the individuals and the institutions, at the end of the day are looking at the future cash-flows, which of course are the dividends, which are very close to the earnings. So it's relatively simple that way, and whatever the discount to cash-flow is and the terminal value, gives you your price. If that happens to be a discount to the book value, so be it. So I think it's best for investors really to look at what you think those distributions are going to be over the long-term. And that's what we do in our own work, is we're constantly evaluating what the dividends are going to look like, rather than what the discount to book value is.

Harry Pangus: So let's actually go to the opposite side of the coin, we talked about discount. There are a number of BDCs that trade at a premium, some of them a substantial premium. I hear a lot of investors say, "Well, I'm not going to buy-in at a premium. It's only worth a $100 and it's trading at $110." What do you guys think? I know this is not a rehearsed question, so we could pass on it. I'm just curious if anybody has any thoughts on that.

Bryce Rowe: I mean, I think it's somewhat simple. The BDCs that trade at premiums now, and there are not many of them, again like I said before, they either stabilize or show a stabilized book value per share over time, or they've been able to grow. Main Street Capital is probably the best example of the outlier. They trade at an 80% premium to book value, but they've grown their book value per share by 80% since going public. And so there's some special sauce there within their investing strategy as well as their operating structure, that allows them to have captured that premium and to have grown it over time.

Harry Pangus: So you mentioned Main Street, I know it's a question coming up later on. They're an internally managed BDC, there's obviously externally managed. Can you talk about the difference really quick between the two for the audience? And it sounds like you're a fan of the internal structure?

Bryce Rowe: Sure. All else being equal, definitely a fan of the internal versus the external structure. An externally managed BDC is going to charge a base management fee, and an incentive fee based on profitability levels. There's a cap on the amount of operating leverage that an externally managed BDC can capture, because their expenses grow with their investment portfolio size and with the assets that they manage. An internally managed BDC has an income statement that looks like any other operating company. They've got revenue in the form of interest income, and then they've got expenses in the from of salary and benefits, and other general administrative type expenses. If you think about it, they can grow their assets without growing their expenses at the same pace. And you actually see that with Main Street and with Capital Southwest, capturing operating leverage as they grow their portfolios.

Harry Pangus: Okay, great. So John gave me the time signal, so I'm going to ask two quick questions. If you guys can answer them quick, I really would like to get these questions out and then we'll open it up to you guys for any questions. So first question for you, Kelly. You focus on the private credit market. We're all waiting. We're in the ninth inning and we're waiting for something to happen. So one, when do you think something's going to happen? And then two, how do you think BDCs are going to fair when, and if it does happen?

Kelly Thompson: So I think the current baseball metaphor is extra innings.

Harry Pangus: Oh, we're in extra innings. Yes.

Kelly Thompson: We're in extra innings. I don't know, for the past six years or so, everyone's been saying two years, two more years, two more years. I've been doing the midtown shuffle this week, doing a bit of reporting for DLD and talking to contacts. And I think the feeling out there is 2020 is probably not going to be a crazy year. And if anything, people are going to want to rush and push deals through before the election. With the candidates being at such extreme ends of the spectrum, I think the thinking is, 2020 get your deals in and then take it from there. How BDCs are going to fair? I would just say the bigger you are, and the more diversified you can play in the capital structure, I think the better of you're going to be when things start to fall apart. You'll obviously be able to absorb more of the problems much more easily. They won't be as big for your portfolio, but also BDCs that can play up and down the capital structure have been able to pivot for the past several years. And they've been able to go where the opportunities are, but they can also change because they have that capacity to do so.

Harry Pangus: Interesting. So the bigger they are, doesn't necessarily mean the harder they fall. So this is the last question, and I'm going to open up to you all. This is my favorite question. No one objected to it, so I'm going to ask it. This is for John, Bryce, and Nick, and Kelly if you want to jump in as well. So if you had one BDC to invest in, which BDC would it be and why?

John Cole Scott: Because I'm a fiduciary financial advisor, and I don't know your current situation, I will answer this question but it is not considered financial advice. So in my opinion for our clients, one of our favorite workhorse BDCs, as in it hasn't been the best headlines like a Main Street with an 80 premium, but it hasn't blown up its portfolio, is New Mountain Financial. The things I liked about it is they have a good origination platform. They do raise capital in the secondary market, but the last time they did it, the price went down a little bit. They're still above book value with their raise, it moved two percent. But they've been very good. Like I said, the things we liked about them when we bought them, and currently own them for our clients where they make sense for them; nice compliance friendly thought. Is that ability to produce revenue for shareholders and to be fair to shareholders. So they're not a very sexy name, but they're a very well respected name in our experience.

Harry Pangus: Bryce, Nick?

Nick Marshi: I'm going to give you a short but complicated answer. The most important thing about investing in BDCs besides the individual BDC, is when you buy it. Because BDCs are so volatile, they zoom up and down. Within a year, a good BDC can go a range of 30%, a bad BDC 60 or 70%. So this BDC that I would buy, I would buy when everybody else begins, or mostly everybody else begins to panic. And usually within a one or two year period, you can have a couple of opportunities to do that. We had one back in December, and we could have another one at any moment. In terms of my favorite BDC, it would have to be somebody who'd been around. Even if there are many good names like New Mountain, who have done a very good job since 2009, I would stick with somebody who has been through the maelstrom before. Because it's no joke when it does happen, because your bad debts tend to increase five to ten times. And that really puts a strain that you're not feeling right now. So I guess I would go in terms of experience, breadth of coverage, and the heft to get through a recession with Ares Capital. Which has been through it all several times over.

Bryce Rowe: So I'm going to take your route there. Timing is everything; 2015, 2016, I had a coverage list of 11 or 12 BDCs, and I went from recommending two early in the year, to recommending the whole list later in the year or early in 2016 because of how far valuations came in. The recession didn't happen and it played out for the better, so I think timing is absolutely everything from a valuation perspective. My favorite one, I've talked about it, is Main Street. Main Street's got a bit of a different model. They do this private debt type capital, but they're also kind of playing the private equity side too. And so what you've seen them do is generate appreciation and gains on their equity investments to the tune of 180 million dollars since going public. And if you look at their schedule of investments now, their setup in terms of their equity investments looks very similar to how it might have looked two or three years ago. So it's a sustainable, recurring investment process, and I think that even though they trade at 80% of book value, you might be able to see that same level of book value per share growth over the next 10 years, just given how they're set up today.

Harry Pangus: Okay, great. So with that I'm going to turn it over to the audience. Does anybody have any questions?

Audience: So somebody was mentioning again, 70% of the assets are private lending, right? Somebody mentioned that some of the BDCs across the spectrum hold the same loan. Do you ever see discrepancies? You did mention there might be discrepancies in pricing, which is an obviously red flag for me, for that company to not even get hired. How often do you see that? And are there any companies that you see doing that more than others?

John Cole Scott: I'll say at the BDC Roundtable maybe three years ago, this came up and I was at that session. This conference is for the BDCs themselves, and the independent board members. It's a lot of deep content. And they said, "Well, we marked this loan at 0.85, and we found this other BDC was marking at 0.75." And I'm guessing on the numbers because it was three years ago. And they go, "And so I called up the BDC and said, 'I'd be happy to pay 0.75, can I buy the loan for you?' And they go, 'No.' 'How about 0.76?' Basically the answer is, if you did granularly, sometimes the same company in more than one investment, sometime it's a different vintage, it's a different environment. Every BDC deal, I'm sure there's some that are the same, are very unique like the syndicated loan market, but I would offer even niche here. And so there is ability with data, like the advantage data Nick talks about, or some of our resources, to look at the holdings and how they're marked. But remember like Bryce said, some of the managers are more conservative. And if you look at the data, you can kind of tell who's a more conservative manager historically, and who's more aggressive. And I think that's helpful. Any other perspective?

Kelly Thompson: I would just say that it does happen. I think you two would probably have a better idea as far how often that happens. I wouldn't say it happens all that often, but it does happen. And as far as BDCs holding the same loan, I think you see that much more when the credit is broadly syndicated credit that's much larger. In which case, those marks are going to be very close and should not be different, because there's a secondary market to check those off. You'd see that on a much smaller investment, in a company with 25 million EBITDA, and maybe there's only that BDC and one other BDC holding that loan. I think that's where you would see more of a difference if there was one.

Nick Marshi: Yeah, you know the BDCs are all watching one another. So if one quarter one group's a bit high, and the other one is low, they'll go and adjust it the next quarter because they'll be people like you saying, "Hey! Why is it different quarter to quarter?" So it's a moving feast of valuation, and it's just based upon the fact that everyone's using slightly discounted cash-flows and evaluations. There's no ill intent in it, and there isn't a consistent policy where you can see that certain BDCs are just being naughty all the time. It's just a difference of opinion, and so I don't worry too much about it when I see variances. And I see variances all the time, because that data is available every quarter with Advantage Data, and I look at it every quarter. They're a closely held private company deal, almost certainly they're going to be a few percentage points difference between the two different BDCs holding it.

Harry Pangus: Go ahead.

Audience: I wanted to kind of expand on that really around valuations. There's a few things you said. You talked about third party valuation firms have increased in the years. And you talked about conservative, and right away honed in on that. First of all, there is a requirement when you value, there's a term called 'generally accepted accounting principles'; GAAP. So conservative isn't GAAP. So you might say, "I value it conservatively." Some might value it aggressively. Technically everyone should be valuing it using the same bot. Maybe they're not, but that's really the standard in which they should be valuing it, right? If they're a publicly traded company, there's only one standard. It's a problem. Privately held companies, it's very difficult to value, which you mentioned. And you said some do it better and some do it worse. It's difficult, it's hard. So yes, it is. But if you're going to take public money, you're going to take investor money and you're going to invest it down in these companies. Well, you should know what you're doing and you should make, you, me, these managers, they should know what they're doing. If they're going to be putting their money down, they shouldn't be putting it into a black hole. So they should have modeling. They should have a better understanding of these companies.

John Cole Scott: Is this a question? I'm sorry.

Audience: No, no. Sorry, I apologize.

John Cole Scott: We're kind of over time. How about you all chat at the happy hour.

Harry Pangus: Sorry, I missed you before.

Audience: Here's a question for whoever wants it.

Harry Pangus: It better be a question.

Audience: Whoever wants to answer it. As you guys know, the middle market lending, a lot of private equity sponsors and borrowers are pursuing private debt versus syndicated executions for their debt. So the middle market syndicated loan space is shrinking, and direct lending or private debt is taking a larger and larger share of the market. So how is that affecting the collateral and BDCs, if at all?

Kelly Thompson: I'm sorry?

Audience: So how is that affecting the loan portfolios in BDCs, if at all? That general trend towards private versus syndicated executions?

Kelly Thompson: I'll take this. I think it's giving BDCs more opportunity to play in a lot of different sized borrowers, and not just the small and no market sized borrowers. And with all of the fundraising and money flowing into direct lending for higher yields, they're also able to do bigger holds. So I would say you're probably seeing bigger holds in any one particular name than you might have seen five years ago. Is that alarming? It depends on the credit. They'll all argue it's a credit by credit basis. But I will say that most BDCs, not all of them, but most of them lend to companies that are backed by private equity. Private equity firms are writing equity checks of about 50%, so they're not just going to let those companies die on the vine if they don't have to. So even though they have opportunities now to take bigger holds, they're playing with bigger sponsors as well.

Harry Pangus: Okay, great. Can I take one more question or no?

John Cole Scott: Sure.

Audience: I know I'm getting in the way of getting between JSC and the bar, and I apologize for it. But one issue that I'd like to address, whomever, relates to the management expenses and particularly the performance fees, and how they're calculated and the variances in that. It does not really receive the transparency that it should in my view.

Bryce Rowe: I agree with you. I think from a structure perspective, the lower the base management fees, is received well. The higher the hurdle rate, is received well. And then maybe the most important piece that's come of interest here lately, is a look back period that will not allow an incentive fee to get paid if there's losses essentially that eat into past profits. So that's an important aspect of the fee structure that has been more prevalent here recently than it was maybe five, ten years ago.

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