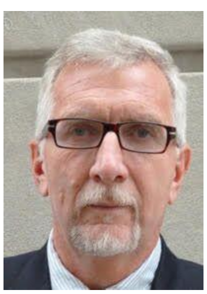
AICA's BDC 1Q 2020 Earnings Season Review and COVID-19 Impact on Middle Market Loans

Thursday, June 11, 2020

On June 11, 2020 we held a webinar to discuss AICA’s BDC 1Q 2020 Earnings Season Review and COVOD 19 impact on middle market loans followed with live and pre-submitted Q&A. Nicholas Marshi, editor of *The BDC Reporter* and *BDC Credit Reporter* and Michael Petro from Putnam Investments were featured. Vadim Avdeychik from Paul Hastings was the moderator.

 Nicholas Marshi	 Michael Petro

PAUL HASTINGS  Vadim Avdeychik	AICA ACTIVE INVESTMENT COMPANY ALLIANCE Excellence beyond indexing  John Cole Scott

John: Good afternoon. John Cole Scott, Closed-End Fund Advisors. Thank you for logging in today for another one of our timely webinar sessions, this time covering the BDC sector. We are recording this session and we do plan to transcribe it, and so we'll hopefully get that posted soon on the AICAlliance.org website. Please go there for a filter and screen for closed-end funds, BDCs, those profile pages. And we have some indices available on CEFdata.com.So I know people are still filing in. If you have a question during the session, please use the question box, and I will do my best to answer all of those questions and send them along to our moderator. So at this point, I'll be happy to turn over the presentation to Vadim Avdeychik, who's of counsel at Paul Hastings to moderate this session. Thank you for doing that today. Let's get started.

Vadim: Thanks John. My name is Vadim Avdeychik. I will moderate this panel today, and I think we will start off with some brief introductions, including myself. I am, as John mentioned, an attorney at Paul Hastings. I focus my practice on BDCs and closed-end funds, and obviously during the last three months or so, it's been an interesting time to participate in this sector and to advise clients. We will now turn it over to Nicholas, who can introduce himself. Nicholas, please.

Nicholas: Hi everybody, I'm Nicholas Marshi. I'm the editor of *The BDC Reporter* and *BDC Credit Reporter*. I'm also a registered investment advisor here in California, and co-head of the BDC Investment Advisors LLC. I've been investing and commenting about the BDC sector for well over 10 years. I look forward to letting you know what I know and I don't know about the BDC sector at this stage.One last comment, my wife wants to thank you for getting me to shave and get dressed for the first time in three months. This is about as good as I've looked, so thank you very much.

Vadim: That's a great point. I've actually put on a collared shirt for the first time in a couple of months. I will now introduce Michael Petro. Michael, can you briefly introduce yourself please?

Michael: Sure. It's Mike Petro, I'm a portfolio manager with Putnam Investments. I run the Small Cap Value Fund. I've also been incubating a BDC only product for the past two and a half years. I've invested in BDCs since at least 2007. I can't remember exactly how far it goes back, but from before the Great Financial Crisis. And I look forward to sharing my thoughts with you today about the space.

Vadim: Great. And last but not least, we have Bryce Rowe. Bryce, can you please introduce yourself as well?

Bryce: Sure, good afternoon. Glad to be here. My name's Bryce Rowe, I'm an equity research analyst over at National Securities. I've been an equity research analyst for over 20 years now, covering both the small cap bank space and the BDC space over that 20-year period. Got to live through the Great Financial Crisis and covering banks through that, and now having the opportunity to live through the COVID crisis with the BDCs. Right now, cover 10 stocks, four national securities in the BDC space, and look forward to sharing my thoughts on the space and on some particular companies with everyone today. Thanks.

Vadim: Thank you for that. Now we can get started with the substance of this webinar. And obviously Q1 has been a challenging time for the market in general, not just BDC companies. But the BDCs and their role in the private credit markets has definitely expanded since the last financial crisis, and I think it's a very timely topic for us to address the Q1 results for the BDC sector, and how the COVID-19 has impacted the valuations. I bet that the valuations at the end of March look a lot different than they did at the end of December.

So with that said, I think we can get started. And Bryce, I'd like to turn it over to you for the first question. Can you please walk us through how BDC valuations or prices trended since the emergence of COVID-19? And what about since reporting on the earnings, and how do you see that looking going forward?

Bryce: Sure, happy to take that one. So if you looked at the average price to NAV within the BDC space, and specifically for the externally managed BDCs, that valuation was trending in a high-90% range really through late 2019 up until about February 20th. And that's when we started to see concerns get reflected within valuations over COVID. In just 23 trading days, the average price to NAV fell almost 60% and bottomed at 41% of NAV on March 23rd. It has since rebounded to 79% of NAV.Of the 29 BDCs that we track, actually 17 have doubled off lows, while the average appreciation off the lows for those 29 BDCs is 101%. So pretty impressive, not withstanding what's happening today within the space. And then of the 29 BDCs that we actively track, 27 are actually higher today than when earnings were released or pre-released with appreciation averaging about 18%. So I think there was clearly a lot of concern over COVID, and since first quarter earnings have been released, the valuations have recovered somewhat. And from a forward-looking perspective, it feels like we might be in a period now where valuations take a little bit of a breather, and I think we're starting to see that a little bit today.

Vadim: Interesting. Thank you for sharing that. And it almost sounds to me as if there is sort of a tale of two cities, the beginning of the COVID crisis followed by the recovery as we move through the pandemic. I guess, how did you see some of the BDCs react during that time? How many BDCs for example, reduced their dividends as a response to the lower valuations and lower NAVs?

Bryce: Right. So far, if my calculations are correct, we've seen roughly 15 BDCs reduce dividend rates, and I might be off by one or two there. Then you've had an additional two that have yet to really declare dividends for the June quarter. You've had a couple BDCs that have in fact deferred dividends all together, and even those that have reduced their dividends down to not paying one at this point. So I think the early look is certainly consistent with what you might expect, but there's likely more to come as we move through the rest of the year.

Vadim: Interesting. Thank you for that. And Nicholas, I wanted to ask you a question. This really has to do with the benefit of hindsight. What was the most reassuring development, if you will, that came out of the March market meltdown and the first quarter of 2020 BDC results? And what was the most surprising thing to you?

Nicholas: Thanks for that. I've been doing this really when I think back about it, since 1999, and I've lived through the 2008-2009 conditions, which were horrific. This latest crisis really was just as bad as things were in 2008 in terms of loan value prices dropping, prices of stocks dropping, and the whole construct getting shaken. So I think the most reassuring thing for me is that the whole BDC model held together. We didn't get any BDC that had a Lehman moment during this time of extreme stress, and I think that's reassuring.Especially, as Bryce knows, in the months before the crisis struck, most of the BDCs had been leveraging themselves up. They had been investing in, let's face it, some of the most aggressive loan borrower-friendly structures that there are out there. And the whole crisis came along very quickly. Even quicker than the Great Recession sort of came upon us. And so the fact that they could live through that without anybody collapsing during that time, I think is a reassuring factor.

Vadim: Interesting. And I think as a follow-up to that, and I can kind of give you my perspective as an attorney who deals with the SEC quite often. I often rely on regulators to act timely in times like this, especially with crisis. If you can come to the industry and to give some relief where it's necessary, so the industry can operate without sort of running into liquidity issues, if you will. And we definitely did see that as the SEC put out some timely guidance on some of the aspects.Are there any parts of the regulatory response, Nicholas, that you found were lacking? I think from the SEC standpoint, they put out exemptive relief to BDCs to be able to raise additional capital and not hamstring their asset coverage. Were there other parts that you think could have been done better?

Nicholas: Yeah, the SEC did, as you say, make it a little easier for BDCs that were right up against their leverage limits because they had overgorged themselves on debt, to potentially still be able to raise debt. But only one BDC took advantage of that, that I'm aware of, and Bryce, correct me if I'm wrong, which was Prospect Capital; and that was only for a very short time until they did some fixes of their own.I think the most important thing that's happened, and it remains to be seen just what its real importance means, is that the government through in that PPP lot. And many, many BDC portfolio companies took advantage, especially in the lower middle market, of those PPP monies. In fact, for some companies that was the only money coming in for weeks at a time and kept them alive. So you have to give the government credit for that, however uneven it was. And I think that was one of the reasons we maybe did a little bit better than we could have otherwise.

Vadim: Absolutely, yeah. Thank you for that. Michael, I'd like to ask you, in light of the Q1 results, which BDC stocks do you see as well set up to outperform from here on? And what are the key factors that go into that determination for yourself?

Michael: Okay, so generally speaking in this environment, I like BDCs that have conservative and well marked books. Especially in cases where I think the market's not giving the stock full credit for their conservative nature. And so what do I mean by conservative book? Firstly, it's going to be a function of the seniority structure. So that means a higher proportion of first lien loans to larger size companies in resilient industries. But then more subtly than that, it's also a function of how the BDC does its valuation process.And so when I look at those two things together, a name that really pops out for me is Barings BDC, and I think it shines on both fronts. So they saw their NAV decline something like 21% last quarter, quarter for quarter. Which is a lot, even with respect to other BDCs. But you have to keep in mind that they're in the process of shifting their book from broadly syndicated liquid loans to originated middle market loans. And so close to half their assets got marked to market with the liquid BSL market quotes that really came down. So in fact, about 70% of that NAV decline was due to the fact of the drop in the BSL market. And so that market went from 97 in Q4 - this is the BSL market - to 83 at the end of Q1, and now it's at about 91 even today. And so while they rode that BSL market down in Q2, they're going to be seeing a large part of their book get marked right back up in Q2. So that's one thing.

And then secondly, they have a conservative valuation process that it doesn't just look at trailing 12 months EBITDA. So at the end of Q1, they're trying to model out what they think EBITDA is going to look like for their portfolio companies in Q2, Q3, beyond, recognizing that we're in a recession. So they're actively considering how the companies are going to respond in this downturn and what the profit is going to look like. And that's on top of the marks to market that they're taking because of spread widening. And that's a really conservative process that I don't think a lot of BDCs are going to share. And then structurally, they have 97% of loans in first-lien assets and they had no non-accruals as of Q1. Now of course, they're going to have some non-accruals I think. They're one of the fitness chains, for example, that's seen a lot of trouble. But they have a really well diversified book, so I don't think their loss is going to be outsized. And then if you look at their leverage, it looks a little scary; 1.42x. But if it's on a net basis, so net of the cash, it's 1.2, not as scary. But again also, with that dramatic markdown in their equity because of the BSL market, that debt to equity ratio is really overstated. So I think as their assets get marked back up, that ratio is going to come down. And in fact, I think they actually have the ability to increase their leverage from here, at a time where market spreads are more attractive, when terms and structures are more attractive. And so I think they're actually increasing their earnings power from this point. And they also have LIBOR floors and other middle market loans, so they're not going to get dinged worse than others. Actually probably less than others by this collapse in rates. And icing on the cake is that they're buying their shares back in the open market at less than NAV. So with the stock trading at 86% of NAV, that was before today's meltdown, I think this is a stock that can both play offense and defense. So I really like that one.

Secondly, I think the venture lending space is very attractive. These are BDCs like Hercules and Triple Point, that lend to venture capital-backed companies. In this business it's less about the immediate cashflow performance of the companies, because let's face it, these are start-ups, they're expected to be burning cash at this point in their life. It's more about the enterprise value you're getting, what the loan's value is, and are the companies executing against their long-term plans? And then it's also really important to make sure that you're doing business with the right venture capitalists. The ones who are both going to pick winning companies most importantly, but are also going to support those companies in any kinds of trouble. And I think that Triple Point and Hercules are partnered with the right VCs. And if you look at the records, their ROEs are really good, and they're very strong, and they have good records. And part of that is from the unique ability they have to actually gain a little bit on NAV. It's not just a case of trying to limit your losses, but they get warrants with their investments. And so now and again you get a really great outcome like Triple Point has CrowdStrike, which has just been on fire. So they can actually cover over some of the losses they're going to have in the normal case of business with gains they have on warrants. So this all adds up to very attractive long-term loss rates that are really superior to most BDCs.

And so if you're looking at in Triple Point's case, a BDC that's trading at 83% of book, the BDC average is at about 90. Again, that was before today. I think you're getting a below average valuation, but at the same time, you're getting an above average ROE. So I think that's a really attractive space as well.

Vadim: Thank you for that very insightful response. I guess this is a good time to pause and to ask anyone who's listening or participating on this webinar, please submit questions. We'd love to get your questions in and ask our panellists as well. Bryce, I wanted to ask you a multi-part question. How do you see the NAV change quarter for quarter? And did you recognize any particular pattern or difference between the BDCs that you cover? And finally, how do you see NAVs rebounding in Q2?

Bryce: That's a good question and it kind of ties into what Mike just talked about with Barings. So again, we kind of actively track 29 that look and feel a lot alike. The average NAV compression in the quarter was about 13%, and most really did bundle around that 13% level. Interestingly, we saw that those BDCs with more exposure to liquid loans, such as Barings or an Oaktree, they actually declined more than the average. And it's perhaps a bit counterintuitive that valuations for larger, seemingly more resilient companies, declined more than valuations of smaller companies that are held within most of the lower middle market focused BDCs. But it was in fact the case.

NAVs of BDCs with more exposure to liquid loans, we think, could rebound in the second quarter here. As Mike discussed, as those liquid loan prices have appreciated, let's call it 8-9% since the end of March. Now that does assume prices hold for the balance of June, and we'll surely see some more COVID impact on fundamentals of portfolio companies with the June quarter, given that it's a full quarter of impact. And I think that will likely lead to more NAV compression for most of the BDCs. We'll have to see how the NAVs of BDCs, with more of a liquid portfolio, how they react here in the quarter. But I'm guessing that you're going to see more NAV compression for the majority of the BDCs out there here in the second quarter.

Vadim: Thanks Bryce. And that leads me to the next question, and Nicholas, hopefully you can cover this for us. But based on what Bryce has just explained, what do you see that we will likely find out in Q2 that we did not see from BDCs and their announcement in Q1?

Nicholas: Okay, I'm going to be a little controversial here to mix it up a bit.

Vadim: Let's mix it up.

Nicholas: I'm going to say that the first quarter told us nothing, because it's almost like we're beginning again with the second quarter where BDCs are concerned. When you think about it, in the first quarter we had earnings which were in most cases, two thirds were good and one third was beginning to be impact by COVID. And then during that time, LIBOR dropped very, very sharply because of everything that was going on. Which will now be impacting for the full quarter going forward. And then before this, BDCs were buying and selling loans as normal, and certainly the brakes got hit. And in the future, there'll be less activity, both buying and selling, and that's also going to change. As also will be, that any new loans are going to be at much higher rates than they were in the past. And also, BDCs already warning us that they are going to be helpful with their troubled companies, but they're going to charge them a lot of fees. And Ares were just saying this yesterday, that they expect their fee income to go up enormously. And that's not a good thing actually. It just goes to show that they have so many companies that want amendments and waivers, and every time you come and ask your lender for that, they say, "Of course. Now just pay here please."

And NAV is going to change, as everyone's been saying, quite dramatically. As many of the loans that were beginning to deteriorate in the end of the quarter disintegrate; like for example, Hertz. Hertz was trading at the end of the first quarter at a small discount to book. Now it's trading at 70% discount to book. And there are many, many other stories like that. Likewise with dividends. Many BDCs paid out dividends in the first quarter, but they're really doing it because of historic earnings that they have, and the requirement of the BDC rules that you pay out your income. Going forward, many of them have already told us that they're going to be paying much lower dividends going forward. So I think in a way, throw away everything you thought you knew about your BDC up till now, and use the second quarter as the starting point for the next several years.

Vadim: That's an interesting point, and I think it's something that we have all seen. I think it's a matter of, do you take your medicine early? Or do you postpone it and take it on later? I think maybe some of the BDCs tried to say, "Well, we don't know what Q2." And hopefully Q2 will look better, but it sounds like it may actually look worse for some of the BDCs.

Bryce, I wanted to ask you a point that Nicholas mentioned about LIBOR during his response. How will LIBOR impact BDC earnings? And any insight into its investment pricing since COVID-19 emerged?

Bryce: Sure. So as you know, most BDC debt investment are floating rate and really tied to one or three-month LIBOR. Three-month LIBOR ended the March quarter at 145 basis points. So that will kind of flow through as the rate benchmark here for the second quarter. LIBOR's gone down by over 100 basis points since the end of March, sitting today at 32 basis points. And so I think the end result there will be that BDC earnings could see a little bit more pressure from lower LIBOR in the June quarter. But then as we move beyond June, those BDCs that have LIBOR pricing floors within their portfolio, you might actually see a little bit of yield support tied to those. And I would contend that most BDCs do have pricing floors set at least 100-basis points. So LIBOR's well below that today.From what we've heard in terms of pricing, pricing's at least 100 or 200 basis points higher than it was pre-COVID. There hasn't been a lot of activity, so it's hard to really gauge that. But I think it's simple to say that pricing is higher, and in some cases it's even higher than the 100 to 200 basis points.

Vadim: Thanks for that. I think this is a good time turn to some of the questions that have come in. I will lead off with a question from Jay from New Jersey. Jay's question is, "Is there a way to determine an approximate percentage of Q1 marked to market reductions of specific BDC portfolio NAVs should lead to an actual portfolio impairment? And is it possible to estimate which portfolios have been more impaired than others?" And I can kind of open that question to anyone that wants. So please, go ahead.

Michael: I guess I could take a stab at it. In general, that's a hard analysis to do. Part of it is, you can look at the portfolio and get an idea of how risky it is, and also to what extent the marks are more market-driven, like I was saying about Barings, and Bryce was saying about Oaktree. A lot of those marks were, we might call them mechanical, because the BSL market went down as I said, 84 in Q1, and is already at 91 now. So you can kind of mechanically get those back. And if you can look at the BDC portfolios, often they'll have in their investor decks, you can see what percentage they have in the broadly syndicated market. So that's a small subset though. Again, names like Barings and Oaktree, where you can do that kind of analysis, and I think that analysis would be favorable, saying that a lot of that market will come back and probably not be permanent. So that helps you in a small set of companies. But then if you want to look more broadly, I think we can look at history. We can go back to the Great Financial Crisis, and I don't have these numbers -- these numbers are out there, but I don't know what they are exactly. But I recall that losses as a percentage of cost were something like in the mid-teens through the cycle '07-2010, 15% and 18% on average. Keeping in mind that's an average and your mileage may vary. So I think we can look at that as sort of a guide post, and say, "Well, is it worse this time or better?" So here are just a few countervailing forces to think about. One is that I would argue that BDC management teams are significantly more sophisticated than they were in 2008. Back then, I think the BDC industry was a little bit more of a mom-and-pop shop, even among the public companies. And today you have investment management teams that are much more sophisticated, and much bigger, well-versed teams running those portfolios. So I would argue that maybe they know a little more what they're doing than they did back then. And then at the same time, I think with something like 40% of BDC portfolios were first-lien back then. Now it's 75 or something, and there are plenty of BDCs that are well into the 90's first-lien. So you would expect to have better outcomes there, that's another reason I argue that maybe it won't be as bad as it was in '08. And then against that, I would say one obvious factor is leverage, with the available of two to one leverage. BDCs did avail themselves of that partially, and most BDCs are levered one full turn now. Back then it was probably more like 65% of a turn, so that's working against you.

And the attachment points, I think the whole private debt space was very hot for the last 10 years, and terms and structures were not very attractive the last few years. So like Moody's for example, has argued there's going to be a higher loss given default rate for all things being equal. So there's a lot of gives and takes there to argue with.

And then on top of that, you have to look at the portfolio construction. If you have exposure to renting airplanes, that's probably a tough spot to be. If you're in retail, that's a tough spot to be. If you're in software, probably not that bad. If you're in, let's say something like dental practices. Okay, now nobody's going to the dentist now. But are they really going to stop going six months from now? You could argue maybe that's just a temporary phenomenon, and if they support those companies, it's not going to be a permanent destruction of value. So a lot to think about there. But for me, I put that all in my hopper, what do I come out with? I think it's not going to be as bad.

Vadim: Interesting. Yeah, it does seem like the face to face businesses have faired rather poorly compared to the more businesses that rely on other parts of their business. Nicholas, Bryce, anything else to add to Michael's points?

Bryce: I think Mike makes a lot of good points there. Especially with the broadly syndicated portfolios, it's an easier analysis to undertake. One thing I found interesting from a management team, Whitehorse, a smaller lower middle market-focused BDC. They marked their portfolio, what I believe to be, properly. And they described those debt investments that were marked down maybe from the high-90% of par down until the mid to low 90s. That might be a good thing to look at to understand where the marks flowed through a particular portfolio. If you see portfolio companies that were marked into the 80s or even below 80 cents on the dollar, then that might be more of a red flag in terms of what's to come in terms of stress. That's one thing I'd add. And the second thing, this go around, there's a lot of private equity sponsorship of these BDC portfolio companies. From what we've heard, generally speaking, those private equity sponsors are being supportive, and so they're injecting cash when cash is needed. And I think that will help keep these BDCs and investments afloat as we move through this crisis. And so that's something that's definitely different this time and should be helpful.

Vadim: Yeah. I think that goes to Mike's point abut the change in the character of the managers that sponsor BDCs since the financial crisis. It has moved away from your mom-and-pop shops into businesses such as Goldman Sachs, Apollo, Ares, and so forth. Nicholas, anything to add to that before I turn over the to next question?

Nicholas: Yeah, I do have a couple things to add. I just wanted everybody else to get their word in edgewise, but I'm actually very interested in this area. So I'd say two things to the person who asked the question. The first thing is, just go to virtually any BDC conference call transcript, and believe me, people like Bryce ask that same question all the time. And you can probably find out, the horse's mouth will tell what percentage they believe of the write-down was due to massive drop, and how much was due to credit issues of a more lasting nature as far as that BDC believes. The second point I'd make is, and here's a bit of an infomercial for what we do, over at the *BDC Credit Reporter*, we basically go and look at every single BDCs underperforming company. And you can see if you go there, that we organize everything by BDC. And we then analyze whether or not a company has a mild problem, a moderate problem, or is headed toward a default or bankruptcy. That might give you, if you're willing to do the homework, more of a sense of what is real and what could be some serious issues.

Like I said, a lot of BDCs that wrote down a loan 10 or 20% at the end of March, you can see in the markets that they're trading at 40 or 50 cents on other dollar. And you have to differentiate those from the ones that were trading down to 90 cents on the dollar and have bounced back to 95. That second group is what's going to hurt you, if in the quarters ahead they start to go non-performing, and you lose the income and you write off a large amount of the capital.

We've only just begun this credit adjustment process that's coming out of COVID-19 because that's still going on. The COVID-19 recession is still underway, and so you can't assume that we're just going to bounce back in one or two quarters. I think this is going to be an 18-month process, and I think Fitch and Moody's pretty much got the same view.

Michael: I have to agree with Nicholas there, history has shown that it takes four to six quarters or more to work through these situations. And so you can't just look at the current quarter and think that things are bouncing back and we're going to be okay from here. This really is a process, just like it is for banks. It takes multiple quarters to get through, and a loan that's marked at 70 can go to 50, can go to 30.

But on the flip side, BDCs can hold positions for the long-term. They can work things out. They can get equity when the loan defaults and then work it out on the other side, and that's a multi-year process. And if you look at the long-term record, I've some data on this, the long-term record of the BDC is actually not that bad. It's actually better than high-yield loans, and about the same as BSL when you factor in realized and unrealized gains. It just takes a long time to get that back.

Vadim: Interesting. So based on what Nicholas and Michael are saying. If I may, the question that comes to mind, it sounds like things may get worse before they get better. How have BDCs done -- what kind of job have they done to raise the necessary liquidity to weather them through the bad times that may be coming ahead? I don't know if you can give some examples of any BDC, what type of capital raising activities they've done. But I think that's an important point to understand as we move to the latter quarters of 2020.

Michael: Yeah, I'll take that too. You've had a couple companies, namely Bain Capital and Golub, that did rights offerings. They got caught with liability structures that were not ideal for this time, just given the speed of collapse and the way that this is a sort of unique recession. In the sense that I don't think we've ever seen a lockdown like this. Like I talked about dental offices before, usually you would look at that and say, "Well gee, that's a pretty stable business." Well yeah, except when there's a pandemic going on. So I think some companies had liability structures that were not really designed for this kind of special circumstance recession. And they got caught in a tough spot and had to raise equity.

To their credit, I guess you could say that they're making lemonade out of lemons here. Bain for example, I don't think they have a particularly bad book. I think it's more just getting caught in an over-levered position. So I don't think they're going to see losses that were particularly worse than anybody else's. But you can't get away from the fact that they raised a lot of equity well below NAV. That just don't go away, so that's a permanent impairment of capital. Yeah, you can make some good loans and try to make it up, but that's definitely a black mark on those guys records, no way around it.

Others have been in tight spots and raised some expensive debt. I know Bain again raised some expensive debt. FS KKR, they raised eight and five eighths or 8.5% debt. I don't know how you make money on that with that incremental cost of capital. They would say, "Well okay, it's just a small amount. It's good for our overall liquidity and safety, and it doesn't really change our overall cost of capital more than 10 or 20 basis points." And that's all true. But you just wish that they didn't have to be in a position to go out and get 8.5% paper. So did they do the right thing? Yes. Am I glad that they had to do it? Absolutely not.

Vadim: Understood. Yes, thanks for that. Nicholas, anything else to add to Mike's points?

Nicholas: I agree with everything that Mike's saying. Two points. For some of the smaller BDCs, maybe ones that you don't cover, but I cover them all for better or worse, have a liquidity problem. Harvest Capital unfortunately, their bank said, "We don't love you anymore," and has essentially asked them to repay the remainder of their balance over 18 months. And Capitale of Finance, to the bigger, has defaulted under its loan, and it hasn't yet arrived that I'm aware of, at any agreement with its lender, so it's got no line of credit. And a couple other BDCs have given up trying to get lines of credit, and are just living off their cash and whatever they sell to create their liquidity.

There's no doubt that a number of players have liquidity problems. And the problem that could come coming down the road, in which all of the CFOs I assume are managing. Is that as your loan value, if your loan values go down, again, because of bad debts or because of the market doing what it's doing today. And if that sustains, that hits the borrowing base on your secured line of credit. Because banks always want to be very secure, a bit like a margin investment. And that could cause BDCs, even the big ones, to get squeezed on their liquidity. I don't think any of them will, as I say, have a Lehman moment. But it's something they've got to be constantly monitoring, and they have to be less aggressive than they might like to be in making new loans or in doing anything. Because they always have to watch out what's coming up behind them that might cause them trouble.

Vadim: Thank you for that. It definitely makes it an interesting environment going forward. I wanted to ask, we received another question from the audience. Ken from New York wanted to know, "What are some of the innovating ways to support secured revolving credit facilities, senior unsecured note holders, while minimizing shareholder dilution?" Anyone?

Nicholas: I'm trying to understand the question. Bryce, do you?

Vadim: What are some of the innovative ways to support secured revolving credit facilities, the senior unsecured noteholders, while at the same time minimizing shareholder dilution. And I think it goes to some of the points that maybe we talked about just now, about raising additional liquidity.

Michael: Why don't you take it, Bryce.

Bryce: I don't know if I have a specific answer per se, but I think a good example is New Mountain Finance, that went into this crisis with a perceivably healthy portfolio, good track record of underwriting, but got caught with a little more leverage than they would have liked. And so what you've seen them do on the liquidity front, is differ their management and incentive fees. So they're still earning them, they've accrued them on the income statement, but they have not pushed out the cash to the advisor. So they're keeping the cash on the balance sheet for potential future use.

The other thing that New Mountain has done, is they've secured a line of credit from their private equity advisor, New Mountain Capital, to the tune of $50 million, so that will certainly be helpful. And then they've also been able to sell a piece of an investment back to their advisor to raise some cash and to de-lever the balance sheet, so to speak. So I think that really speaks to getting creative and minimizing shareholder dilution. It's a way to not have to directly raise equity or directly raise capital, while also minimizing shareholder dilution. And I think it also speaks to the value of a platform behind the BDC that can really support when times get tough.

Michael: Yeah, and also Saratoga, they omitted their recent quarterly dividend, and that was really a shock to the market because I think anybody would look at that and say they didn't need to do that. They even had their NAV go up because they made a really fortuitously timed sale of business that supplies ice to bars and restaurants before COVID hit. So that's just the way to conserve cash. I think maybe they were being exceptionally conservative because they're in an off quarter. Their quarter ended in February, so they were reporting a month earlier than everybody else that was right in the thick of the crisis. So maybe they were being more conservative than they needed to be. But that's something you can do too, is cut your dividend. Even maybe if you don't need to as much, but just do it anyway.

But really, there isn't a lot you can do. You have to kind of have the right structure going in. That's the right answer; is to have the right structure with a nice laddering of secured and unsecured liabilities laddered out in time going into a crisis.

Vadim: Yeah, and I guess I will add from that perspective as someone who deals with BDCs and their boards. In times of crisis such as this, you're also dealing with your board of directors and their view on the company. And perhaps Saratoga's conservative approach may be a function of their board, and maybe the manager's outlook on the future. Nicholas, anything to add to Mike's and Bryce's points on the question?

Nicholas: Just a little point. I agree with both of what they're saying. Those are creative ways to handle making sure you have enough availability under your revolver so your secured debt is okay. I think the secret and quiet way that most BDCs are going to do, that you won't see any press releases about, or big announcements at any time, is that the BDCs w ho feel that they're a little bit tight on their secured debts and who don't want to go and raise expensive money like Michael was talking about. What they're going to do is, every time a loan does get repaid, the chances are they won't go and take that capital and go and lend again.

So you're going to see many BDC portfolios shrink in the short run. And the same way a stock market investors, many people when they see the market being a bit tight, they go to cash. Well, I think many BDC managers are going to sort of sit there quietly and try and de-leverage their balance sheets simply by paying down their debt from whatever loan repayments do come in. And a few are coming in from M&A transactions and things like that, and from the regular amortization. It's not much, but every bit counts. And so I think that that's the way that many BDCs will slowly reflate the availability under their secured lines of credit.

Vadim: Interesting. Bryce, one question for you that I had was, how have the broader market spreads trended during COVID-19 versus other periods of credit market dislocations?

Bryce: That's a good question. Kind of an interesting thing to observe. So we tracked spreads using the St. Louis Federal Reserve data, and specifically look at the single B U.S. high-yield option invested spread, and that's the metric we like to use to track this. So that spread spiked from below 400 basis points going into this crisis to roughly 1200 basis points in the middle of March. And it's receded since, coming back to about 600 basis points today. If you look at the great Financial Crisis, that single B spread spent 10 months over 1000 basis points. So pretty unprecedented in terms of credit spread widening in that period of market dislocation.

You've had a couple of other periods. Here over the last 10 years. The Euro crisis in 2011 and '12, didn't see that spread spike above 1000, but the spread did stay above 500 basis points for an extended period of 400 plus days. And then look at late 2015, early '16 during the energy price climb, note that the spread actually did not go over 1000 basis points in that case either. And it only remained above 500 basis points for roughly 300 trading days. So if you look at it today, the spread is right around 600 basis points, and we've been at 500 or higher for 73 days. So we're still certainly in the early days if you think about those other time periods.

Vadim: Very interesting. One of the things that I think about as we're coming out of this most recent crisis, and since the Great Financial Crisis, I think the BDC sector has grown tremendously. And I don't know if all of you have any data on this, but how do you foresee the consolidation? Or do you foresee consolidation in the BDC sector? I know we mentioned some BDCs that may be struggling with their liquidity while others may be doing a little bit better. I don't know if any one of you have a viewpoint on any potential consolidation in the BDC sector going forward as a result of this crisis.

Nicholas: I have some thoughts on this. Because I'm so old, I've been there right through. I remember when we only had 21 BDCs at the time of the Great Financial Crisis, and now we're up to 45 public. There's a definite process going on that's been happening for the last five years, and that's the big asset managers are becoming bigger and bigger. And they are growing from their own capital raising, and also they're bringing in their brothers and sisters and merging them into their own existing BDCs.

Just today Goldman is talking about merging its sister BDC into itself, which will double its size. Golub did one just a few weeks ago. FS KKR has done it and will be doing it again. The large BDCs now represent 80% of the assets of the market, but only a much smaller percentage of the total number of players. And at the bottom of the market, the smaller players, many of them are troubled. They don't really have a reason to exist, and I expect many of those to probably be absorbed by other players;, large asset managers or medium sized asset managers, or liquidate. And so we might have a situation where the industry is growing while it's shrinking, if you follow me. Where Goldman and Golub could add yet more of their private BDCs in the public BDC space, growing it. While the number of BDCs could shrink when - I won't mention names - but some of the smaller guys might get absorbed or disappear. So good news, bad news, but complicated picture.

Vadim: Probably it's not just in the BDC sector that we're seeing, it's probably in the asset management industry in general.

Michael: Okay, so you're also seeing activists in the space now. After the long battle with Tick, now Oxford Square, that didn't work out. Activists have not given up, they're in the space, and I think that small underperforming public BDCs are going to be under external pressure as well. So it's just going to accelerate the process.

Vadim: That's a great point. I think historically we have seen activists in the closed-end fund space, and maybe activism in the BDC sector is relatively new. And actually yesterday, I saw the news that Harkness and the London firm are merging together, which I thought was an interesting news and will give them a little bit more scale when it comes to being an activist in the space.So we're coming to an end of our call here today, and I just wanted to turn it over to all of our panellists for any final thoughts. We can start with Nicholas, anything you want to conclude with?

Nicholas: Well first, thank you all for listening and bearing all this with us. And I would just say what I said a little earlier just to make the point again. The second quarter will be even more important and even more interesting than the first quarter, so stayed tuned, it's going to be an interesting ride.

Vadim: Thank you for that. Mike?

Michael: And I also would like to offer my thanks to the AICA for offering this platform and for helping educate the investor base. I'm happy to be a part of it. I remain a believer in BDCs. I think that this is obviously a tough time for them. I think the press has been against BDCs for many years. *Bloomberg* seems to be on a vendetta. But I think that if you look at the record, BDCs actually can add value. As long as you're not using the money to pay your kids tuition and can tolerate the volatility, I think it can be an attractive investment space. So let's stay tuned. As Nicholas said, it's going to take a while to work through all this. But BDCs survived 2008, and they're going to survive this.

Vadim: Good point. Bryce?

Bryce: Yeah, I would say thanks everyone for listening as well. It's going to be interesting how 2020 plays out. I think in March we saw some excellent opportunities to go long BDCs, and we're at a point now where valuations could still be considered attractive. It certainly would be a little less aggressive than we were investing in March, but I think there's still some opportunities out there in the space. Always to be selective when it comes to which BDCs you own. It's harder when BDC valuations are higher to state the obvious, and I think it's easier w hen they're lower. So we look for opportunities to remain active in the space, telling people to buy when it's attractive and then to hold off when valuations get too high. So thanks again.

Vadim: Yeah, thank you for that. I'd just like to echo everyone and thanks to John and AICA for continuing to support this market and putting on these timely and very educational calls. John, we thank you for this and just want to turn it over to you for any final thoughts.

John: Sure. I remind people that we're transcribe this session and post the replay pending compliance approval from all of you guys. And also, we have a few minutes left, I'm going to ask you to give two quick things. Your favorite BDC now, knowing the future is not certain, and it's a suggestion. And what's the one thing you would tell an independent board member of a BDC through this environment. What's that one PSA for them and your current favorite pick?

Vadim: Go ahead, Mike.

Michael: Okay, I'll start. I think I've already given my favorite, it's Barings in this environment for the reasons I outlined. And then as far as what I would suggest to an independent board member, is to give BDC investors some credit here, and by that I mean we want you to be as fair and accurate in valuation marks as you can. BDCs, going back many years, had a history of not marking books well, and this is your time to step up and have a fully transparent and accurate mark.

Vadim: Bryce?

Bryce: Yeah, I would agree with Mike. I would also tell a board member to really think about the dividend and where it's set. You don't have to be married to a certain level. I know it can be a little stressful for the market when a dividend is changed, but maybe think about a different construct where there's a base dividend and a supplemental that can vary on a quarterly basis. Because too often you see dividends maintained at a certain level, and they probably need to come down to more rational levels so that you are not over paying and bleeding into book value.

I think the top idea for me, Mike mentioned it earlier, is Saratoga. We're on record as saying it is a top idea. They deferred their dividend as Mike pointed out, and I think that led to a negative reaction in the market, and has created a tremendous buying opportunity. The stock's trading 60% give or take of NAV, and they've got considerably less leverage than most BDCs do, and a portfolio that has really performed well. So I would be getting aggressive on that particular BDC equity.

Vadim: Interesting. I would just add to that point that from our perspective obviously, valuation is paramount. The SEC has recently put out a proposal to revamp the valuation practices that go back many years to kind of take a fresh look at it. So that proposal is out there and boards should be aware of it. Valuation is always important, but especially during times of crisis.

One other point I would add is that if an activist comes calling, boards need to be aware of when they do. And make sure that they have a good report and record in terms of what they're doing and measures that they're looking at. Whether it's decreasing a dividend, increasing a dividend, considering other forms of leverage, asking the hard questions from the managers. So if there's ever a proxy fight, they have a good record to support they're looking after shareholders.

Nicholas, any final thoughts before we wrap this up?

Nicholas: Very quickly, my pick just changed it's name. I've forgotten it's new name already, but it's TPG Speciality, which goes by the ticker TSLX, and does focus on being more of an asset-based lender. Which is the perfect place to be right now in a difficult market, as opposed to in second-lien or in equity. And it's done very well, I'm not teaching anybody anything they don't know.

And secondly, in terms of telling a board, I think this is a golden opportunity with so many valuations going to heck and with this environment, for the boards to have a hard look at the portfolios and get rid of value down to zero, or actually get rid of zombie companies that so many BDCs have within them. Where they haven't paid any interest or any income in years. Their equity is being carried but it doesn't seem to be any chance of it ever being sold. And yet, investors are still paying management fees on those assets. I think it's time to have a hard look at those assets and give a little bit, like what Bryce was saying, a clean balance sheet portfolio list to look at.

John: Perfect. I'll just say thank you. My favorite thing is to sit here and listen and learn from each of you. As I've known some of you various places; I met Michael at the BDC Round Table. And Paul, we met when I was starting to form AICA. And Bryce, we worked together a thousand years ago. And Nick, we've actually met in person, spoke at the conference last year, and we had breakfast way pre-COVID.

So thank you. You each have a different role in the sector at a tremendous value. I'm so glad this worked out and we look forward to doing more of these in the future based on demand and interest. But we had great, great turnout for this, and it's because you guys are well respected and did a great job. So thank you, with that, we're going to say good afternoon and good luck investing everybody.

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