Oppenheimer's Penn On How BDCs Might Fare When The Rate Cuts Start

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Mitchel Penn, Managing Director of Equity Research at Oppenheimer and Co. Read the Q&A below as Mitchel says that while business development companies (BDCs) have struggled this year, they are positioned well to ride out the changing interest rate cycle. He says that when the Federal Reserve starts cutting interest rates, he expects BDCs to see higher fee income, though some of that could be offset by a higher level of defaults. However, he notes that because those defaults are a hangover from high-rate conditions, they have already been priced into many portfolios, creating a cushion against potential credit losses. Penn also discusses the kinds of BDCs that balance out the current risks and that historically have generated high returns on equity with low credit losses, naming several BDCs that fit that description.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Mitchel Penn, managing director of equity research at Oppenheimer and Co. is here, we're talking business-development companies now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the entire closed-end fund business from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction.

And today, The NAVigator's pointing us in the direction of BDCs with Mitchel Penn, managing director of equity research at Oppenheimer and Co., learn more about the firm at Oppenheimer.com. And to learn more generally about BDCs, closed-end funds, and interval funds go to AICAlliance.org, the website for the Active Investment Company Alliance. Mitchel Penn, welcome back to The NAVigator.

MITCHEL PENN: Thanks Chuck, it's good to be back.

CHUCK JAFFE: We're talking BDCs this year, and we need to sort of start with where we have come in terms of its been an interesting year on the interest rate cycle, and then where we're going because of course the interest rate cycle is about to change. So let's start with your take on BDCs this year to this point.

MITCHEL PENN: Sure, Chuck. So BDCs this year are down about 2% year to date, as the Fed has held rates constant, inflation expectation to come down and economic growth has appeared to slow. In the second quarter, ROEs have averaged around 6.5% for the group as net interest margins declined 21 basis points to 8.09% as credit spreads tightened, and net realized and unrealized losses were 228 basis points, up from 54 basis points the prior quarter. So let me give you a little bit of detail on that, basically what we've seen is ROEs that typically run around 8% to 9% a year, they're down at 6.5% in the second quarter, and that's really because of two things. You've had increased competition which has driven spreads on loans down, and that's pressured NII margins, and you've also had higher credit losses, that's really being driven by idiosyncratic losses. We haven't seen systemic losses across the board, this is more one-offs from different companies. And the best comparison, we always look at the high-yield index, and the option-adjusted spread for the high-yield index is in the mid-300s, if it hits 600, that would indicate you're close to a recession. So it's well below that, and it's actually well below the historical average of 450 basis points, so the signals in the market are such that the economy should be okay. So that's sort of a recap of where we are, and the question now, and I think you alluded to this in the beginning, is where are we headed? Our best guess is the Fed likely starts to lower rates over the next six months, which should help the borrowers. So the borrowers, because rates had risen about 550 basis points over the last couple of years, they've been struggling to pay those interest charges, and that's what we saw on Q2 were some of the issues. And so if the Fed starts to lower rates, remember these are all floating rate loans, those borrowers will start to see some relief. Now when the Fed

lowers rates two things will happen likely, prepayment speeds will pick up at the BDCs and that'll lead to higher fee income, so even though rates are coming down and the yield on portfolios will come down, they'll see higher fee income in the first six months to a year. We also think that over the next six months to a year you're likely to see higher defaults, and that includes distressed exchanges. The reason is that you've got a lot of these outliers, these companies that have struggled and they're just holding on with these higher rates, and we think that you'll continue to see these sort of idiosyncratic losses. Now the good news is that BDCs have marked to market their loan portfolio every quarter, so a lot of these losses are already built into their portfolio, and if you look at the BDCs as a group, their loan portfolio's currently marked on average at around 96% of cost, so it gives them about a 4% of reserves. So even though you could see higher defaults, the losses may not be as dramatic because you've already booked a lot of those losses along the way as these credits have deteriorated. We think credit losses likely range between 75 and 175 basis points compared to the 100 basis points you'd expect in a normal environment. ROEs are likely to be within 3% of 9.5% that we saw in 2023, so you could range from 6.5% up to 12.5% in ROEs, so we're not forecasting a major problem and that's reflected really in the value the shares are trading around book right now, so we sort of see that as fairly valued.

CHUCK JAFFE: There's value there but not necessarily bargain basement value.

MITCHEL PENN: Correct. Correct. You know, if you go back a couple of years when the BDCs were trading at 90% of book or 85% of book, there were plenty of values, but when you're trading at book, you're upside is 10-15% and your downside in a recession could be 20%, so it's fairly valued from our standpoint.

CHUCK JAFFE: How have BDCs historically performed in long-term rate cut environments? Because forget about the first one and whether it's going to be a quarter of a point or half a point, although everybody's now expecting a quarter point and happening in the next week, this is something that's going to be extended presumably well into next year and maybe even beyond. How do BDCs typically perform when we're in an environment of falling rates?

MITCHEL PENN: We don't really have the evidence because BDCs aren't that old, and we just published a report on falling rates, 100 basis point rate decline is about 1% ROE, so if a BDC in this higher rate environment is doing an 11% ROE, return on equity, and so the Fed lowers rates 100 basis points, it'll go from 11% to 10%. The other thing you have to keep in mind is

when the base rates are being lowered, the equity discount rate on the BDC will come down as well, so we don't anticipate rates falling having a major impact on the valuation, it will affect the dividend. You should think about it like bonds, right? When interest rates fall, the rates on bonds will come down but the value of new bonds don't really change too much, it depends on the duration. Remember, BDCs are floating rate loans on the asset side, and on the liability side they can borrow fixed or floating. There can be a little bit of a mismatch, but again, nobody's taking out debt longer than five years so we don't see too much change. If you wanted a perfectly matched BDC, TSLX runs a matchbook with floating rate assets and floating rate liabilities, so the falling rates shouldn't have a dramatic impact either way on that.

CHUCK JAFFE: Well, you mentioned TSLX, let's use the limited time we've got left to talk about a BDC or two that looked particularly appealing.

MITCHEL PENN: So in this environment when BDCs are fairly valued, we recommend that people use a portfolio of BDCs, so to diversify their exposure, and we also recommend that they stay with BDCs that have generated high returns on equity and they don't generate very high losses. Those names would include Ares, ARCC, CCAP, which is Crescent Capital, OBDC or OBDE, which are Blue Owl, they're going to merge, that's why I include both of them, and then TSLX would be our final name in that group, and those are names that have generated high returns on equity over long periods of time and they've had very low credit losses along the way. You just want to be defensive just in case the economy slips into a recession, they should be fine.

CHUCK JAFFE: Mitchel, great stuff, always is when we get a chance to catch up. Thanks so much for joining me on The NAVigator.

MITCHEL PENN: Thanks, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yep, I'm Chuck Jaffe, and I'd love it if you'd check out my hour-long weekday podcast by going to MoneyLifeShow.com or by searching for it wherever you find great podcasts. And if you're looking for great information on interval funds and closed-end funds, and yes, business-development companies, please go to AICAlliance.org, it's the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Mitchel Penn, he's managing

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