SNL Blogs

SNL NASHVILLE NOTES

Tuesday, September 01, 2015 1:08 PM ET

August is the market's new October, but not for BDCs this year

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL Financial contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

As a post-mortem to my Aug. 4 post, second-quarter earnings for most of the business development companies (BDCs) were better than I expected. I was not expecting big shortfalls relative to analyst estimates, but the six-year credit recovery is getting long enough in the tooth that most surprises for lenders and investors will be negative — at least at the margin. A number of BDCs over the past year have seen reductions in net asset value (NAV) due to realized and unrealized losses in the investment portfolio. Among the larger BDCs, Apollo Investment Corp.'s NAV declined 8.4% from a year earlier; Fifth Street Finance Corp.'s declined 6.0%. Some have cut dividends.

The market got the message that second-quarter results for most BDCs were OK. BDCs have been an abysmal sector much of the past year, though not August. That is ironic because August has become the new October in recent years when volatility increases and prices tend to fall. The SNL U.S. RIC index, which includes BDCs, declined 1.3% during August compared to a drop of 6.4% for the Russell 2000. Over the past year, the index declined 16.0% compared to a drop of 1.27% for the Russell 2000. Inclusive of dividends, the comparison is not so lopsided because BDCs have to distribute 90% of taxable earnings as regulated investment companies. Still, price action in the BDCs should be disconcerting to investors.

For the most part, there were no big realized and/or unrealized losses that clipped NAV. Each portfolio is unique, but a relatively stable market for leveraged loans during the quarter likely played a part. According to Thomson Reuters, the average secondary market bid for institutional term loans was 97.35 at June 30, which was little changed from March 31. Leveraged loans subordinated siblings, high yield bonds, experienced a little bit of tightening during the quarter. The spread on the Bank of America/Merrill Lynch high yield index for "B" rated bonds narrowed 8 basis points during the quarter to 5.03%, though the spread as of June 30 had widened 154 basis points from a year earlier when the drop in oil and other commodities was gaining steam. It may be that third quarter results will reflect more unrealized losses since spreads have been widening this quarter.

Buybacks seem to be moving up the priority list for management with most shares trading well below NAV and therefore precluding share issuances absent shareholder approval. Buybacks below book value per share are accretive, though there is a cost in the form of increased leverage. Unlike a commercial bank, the capital cannot really be replenished absent a share offering given the distribution requirement of a RIC. And if loan prices trend lower or wider spreads produce higher coupons for new issues, then using the capital to lend might be a better use.

While leveraged loan pricing was steady during the quarter, the asset class that retains a mystery meat designation among some investors, analysts and me is CLO equity. Is its intrinsic/fundamental value captured by market transactions? Have the boards correctly marked the positions? I have no idea, but the market has its doubts.

THL Credit Inc. announced that it has decided to exit the space given investor confusion even though management was satisfied with performance. Post quarter THL sold two equity positions close to the June 30 marks according to management during the analyst Q&A. Management of Prospect Capital Corp. indicated it continues to work on spinning out a portion of Prospect's $1.1 billion CLO equity portfolio in addition to its online lending and real estate units. Aside from having first to clear the SEC, my take on management's comments is that it would not be brow-beaten into spinning if the economics did not make sense. Price discovery will be interesting, but market conditions can change for the better or worse before (or if) a transaction occurs. Given leverage inherent in CLOs, the impact on the residual interests will be magnified. (See my earlier comments on the transaction here.)

A quiet quarter notwithstanding, I think BDCs (and the leveraged loan market) is a sector to watch for bank investors. The sector may not be sufficiently liquid or owned among institutional investors to provide an unequivocal view of where credit is headed, but it is a good data point to add to a mosaic. Poor share performance the past year may prove to be a resetting of valuations in reaction to limited haircuts to NAV and dividends; or, maybe the market senses the credit cycle for leveraged borrowers is too stretched. My predisposition is the former, especially if the Fed does not cause liquidity to flow out of the credit markets with one or two rate hikes that may never happen. Whether wrong or right, the margin of safety in the BDC sector is better than it was a year ago given the drop in prices.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.