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BDC earnings will be more interesting than the banks' reports

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The second-quarter reporting season for commercial banks is largely over; it did not convey much new information. Little outwardly has changed the past couple of years beyond a pick-up in loan growth among regional banks and the impact of the drop in oil prices on energy portfolios. Reserve building for energy portfolios was no surprise, but an interesting asterisk to the quarter was Capital One's reserve build for exposure to taxi medallions. Technology is radically changing business models. Uber Technology Inc.'s impact may be an early heads up for what's coming. Beyond the business models of their borrowers, technology may force the banks to radically rather than incrementally shrink the branch networks.

Although it too may be a ho-hum reporting season, I think the business development companies will be more interesting. BDCs are the edgier alter ego of commercial banks that occupy a corner of the shadow banking system. Regulatory initiatives like the 2013 guidelines that limit banks' participation in the leveraged lending market, easy monetary policies that have left investors starved for income, and narrowing credit spreads between the third quarter of 2011 and mid-2014 have been a great operating backdrop.

Unlike commercial banks the marking-to-market (or model) of the investment portfolios provides greater transparency into the value of the assets. BDC portfolios vary greatly, though there tends to be a focus on first lien leveraged loans with varying amounts of second lien, mezzanine capital and private equity investments. Mix matters in terms of comparing results as does the trend in industry sector credit spreads. Nevertheless, realized and especially unrealized gains and losses are the line items to watch when the earnings reports are released beginning this week.

Where the BDCs are particularly useful for bank investors is an early read on emerging commercial credit trends that are not masked by excess loan loss reserves. Last year and during the first quarter of 2015 it was energy; maybe it will be something new this year. Apollo Investment Corp., which will report fiscal first-quarter earnings Aug. 6, posted $10 million of realized losses and $54 million of unrealized losses in its investment portfolio in the quarter ended March 31. A year earlier the company reported $20 million of realized and unrealized gains. Its experience is not unique, nor is the 19% reduction in its shares over the past year through July 31. SNL's U.S. RIC index declined 13%.

Values at times can be disputed, as has occurred with Prospect Capital Corp. Investors are focused on its portfolio of CLO equity and subordinated debt tranches that the company is trying to spin into a new entity (Prospect Yield Corp. LLC) that I covered in a post earlier this year. Prospect's shares are down 33% over the past year. There may be little if any overlap in the portfolios, but Eagle Point Credit Co. Inc. provides an indirect market check because of its investment focus on CLO equity and subordinated debt. Eagle Point incurred a modest negative mark in the first quarter. Its shares are up about 2% through July 31 since its IPO priced Oct. 7. Maybe the market has overdone the sell-off in Prospect's shares, or maybe Eagle Point gets less scrutiny. Also, Eagle Point hiked its quarterly distribution by 9% on March 3, which is in contrast to a number of BDCs including Prospect that have cut dividends. Results for both will be interesting to see, though the CLO equity issue is not a commercial bank issue.

What might be an emerging trend that is visible in BDC results this quarter? Broadly defined retail may provide a few surprises. Consumer spending is sluggish and under intense pressure from Amazon. Retail-related write-downs could show up in bank provisioning in the fourth quarter or first quarter. Non-BDC specialty lender TAL International Group Inc. saw its shares tank 12% last week following the release of earnings. During the conference call management cited "lease pricing pressure and decreasing disposal gains" in addition to the absence of the typical summer pick-up in leasing demand for containers due to weaker international trade.

As for the pace of investment, CIT Group Inc. management commentary implied sluggish is what should be expected. During its July 28 earnings call, CIT indicated middle-market lending was "slow" and negatively impacted by lower M&A activity and reflected spread compression in some sectors. Thomson Reuters data indicates that leveraged lending (both middle market and large corporate) in the second quarter declined 10% from the year-ago quarter, though the decline was not nearly as bad as the 57% year-over-year reduction that occurred in the first quarter. BDCs may buck the trend — at least at the margin — because they are a natural source of replacement financing for the banks in middle market transactions.

BDCs have similar issues as banks in terms of the pressure on loan yields, though I have been surprised at how yields have seemingly held for the past year or two. Maybe BDCs benefited from some pricing power as banks pulled back from lending to companies levered over 6x EBITDA. It is hard to see how low teen yields hold before factoring in any Fed rate hikes.

PennantPark Investment Corp. Chairman and CEO Arthur Penn offered this perspective in May during the company's most recent earnings call: "As credit investors, one of our primary goals is preservation of capital. If we preserve capital, usually the upside takes care of itself." The discount to book value (or net asset value) that PennantPark and other BDCs trade indicates the market is not so sure about preservation of capital and/or the sustainability of current dividends (PennantPark's yield was 14.1% as of July 31). Maybe the discounts will attract more value investors. Omega Advisors Inc. CEO Leon Cooperman, who is one of the most successful hedge fund managers on Wall Street, touted THL Credit Inc. in addition to a few mortgage REITs last week. Cooperman is not infallible, but his interest in pass through income plays such as THL may draw other value investors and maybe a revaluation of the sector provided dividend cuts are largely over and realized and unrealized credit losses subside.

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