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# W(h)ither Yields? Dividend Capacity & BDC Stock Prices

A Mortgage REIT Case Study



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## A Mortgage REIT Case Study

*The sustained low yield environment is pressuring BDC earnings. If BDCs implement modest dividend cuts, will stock prices decline to maintain investor yield, or will investors accept lower stock yields amid a dearth of compelling alternative income plays? The experience of mortgage REITs examined in this whitepaper suggests that erosion of NAV per share from credit-related writedowns is a bigger threat to stock prices over time*

Second quarter results for BDCs reflected an operating environment characterized by stable, but uninspiring, loan demand and continuing pressure on asset yields. While commentary from Wall Street and even some at the Fed points to modest increases in short rates in 2015, prospects for meaningful yield relief for lenders from future Fed actions remain uncertain.

Table 1 summarizes aggregate results for a group of eighteen of the largest public BDCs from fiscal 2009 through the present. Year-to-date results for the group reveal nearly a full point of yield compression, which has been partially offset by operating expense reductions and greater financial leverage.

**Table 1: BDC Return Composition Analysis**

	Annualized					
	FY14	FY13	FY12	FY11	FY10	FY09
BofA ML US High Yield Master II Effective Yield	5.4%	6.1%	7.0%	7.8%	8.3%	13.8%
US Primary Market Loan Yields (Middle Market)	5.8%	6.2%	7.3%	7.6%	7.7%	NA
Gross Asset Yield	11.28%	12.25%	12.17%	11.72%	11.89%	11.81%
Operating Expenses	3.63%	4.00%	4.24%	4.07%	4.16%	3.69%
Net Asset Yield	7.65%	8.25%	7.94%	7.65%	7.73%	8.12%
Leverage (Liabilities/Assets)	0.42X	0.39X	0.37X	0.36X	0.36X	0.38X
times: Funding Cost	4.49%	4.64%	4.66%	4.34%	3.50%	2.92%
Leverage Carry	1.90%	1.80%	1.74%	1.55%	1.26%	1.12%
Leverage Multiplier	1.73x	1.64x	1.60x	1.55x	1.56x	1.62x
<b>Investment Income ROE</b>	<b>9.96%</b>	<b>10.54%</b>	<b>9.89%</b>	<b>9.49%</b>	<b>10.09%</b>	<b>11.35%</b>
Dividend Payout Ratio	1.05x	0.92x	0.99x	1.02x	1.03x	1.09x
Price / Book Ratio	106.3%	109.0%	107.6%	102.6%	111.9%	95.5%
<b>Shareholder Dividend Yield</b>	<b>9.8%</b>	<b>8.9%</b>	<b>9.1%</b>	<b>9.4%</b>	<b>9.3%</b>	<b>12.9%</b>
<b>Full-Distribution Yield</b>	<b>9.4%</b>	<b>9.7%</b>	<b>9.2%</b>	<b>9.2%</b>	<b>9.0%</b>	<b>11.9%</b>

Based on aggregate results for 18 BDCs (ARCC, PSEC, FSIC, AINV, FSC, SLRC, MAIN, GBDC, NMFC, PNNT, TSLX, HTGC, BKCC, MCC, TICC, TCPC, TCAP, TCRD). Mercer Capital analysis based on SEC filings and data from SNL Financial.

BofA ML US High Yield Master II Effective Yield obtained from St. Louis Fed's FRED database.

US Primary Market Loan Yields from Thomson Reuters LPC Leveraged Loan Monthly.



BDC management teams may find it difficult to further cushion returns against declining yields through lower management fees or greater reliance on financial leverage.

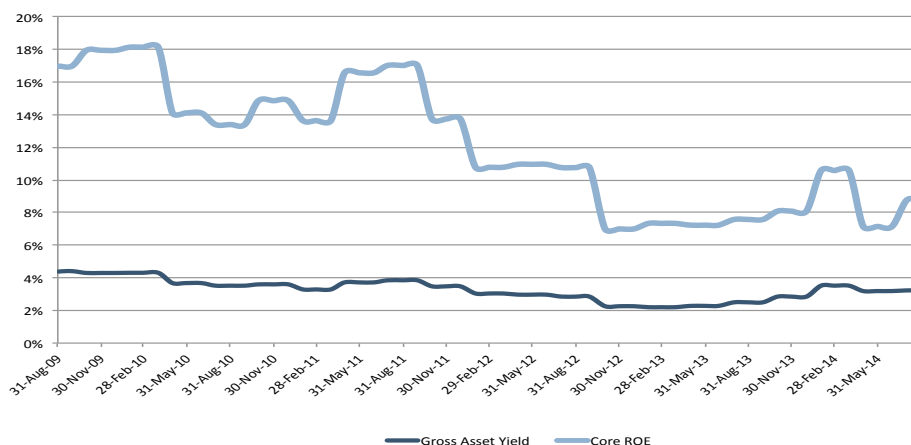
- » For externally-managed BDCs, the contractual management fee consists of a base management fee and an incentive fee. While lower asset yields will reduce incentive fees, the (larger) base management fee is essentially fixed, absent modifications to the management contract or fee waivers. The operating costs of internally-managed funds are largely fixed, and are much more dependent upon the size of the portfolio to be monitored and the deal flow to assess than on coupon levels.
- » Financial leverage is subject to statutory limitations. As noted on Table 1, leverage (total liabilities as a percentage of total assets) at the end of 2Q14 stood at 42%, compared to 36% at the end of 2011. While there is a proposal pending before Congress to increase the amount of leverage available to BDCs, the outcome remains uncertain. Aside from statutory restrictions, the discipline of the market remains. It is unclear what rates and terms lenders would extract from BDCs in exchange for greater leverage, or how shareholders would embrace a riskier equity position.

Despite the steps taken to preserve returns, dividends paid by BDCs during the first half of 2014 outpaced net investment income, as only three of the eighteen BDCs sampled reduced dividend payouts during 2014. Unless asset yields reverse trend, it seems reasonable to conclude that investors in the space will be facing additional dividend cuts in the coming quarters. Tepid market returns for BDCs thus far in 2014 suggest that investors have at least begun to take the reality of tighter yield spreads into account.

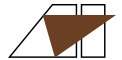
## Perspective from Mortgage REITs?

The experience of mortgage REITs over the past five years may provide some perspective on market reaction to reduced dividends. On balance, mortgage REIT managers have faced a much more severe and sustained yield squeeze than BDCs are likely to endure. Chart 1 below depicts asset yields and core ROE (excluding gains/losses and other non-operating items) for Annaly Capital Management (NLY), which largely invests in Agency mortgage-backed securities.

**Chart 1: Gross Asset Yields and Core ROE for Annaly Capital Management (NLY)**



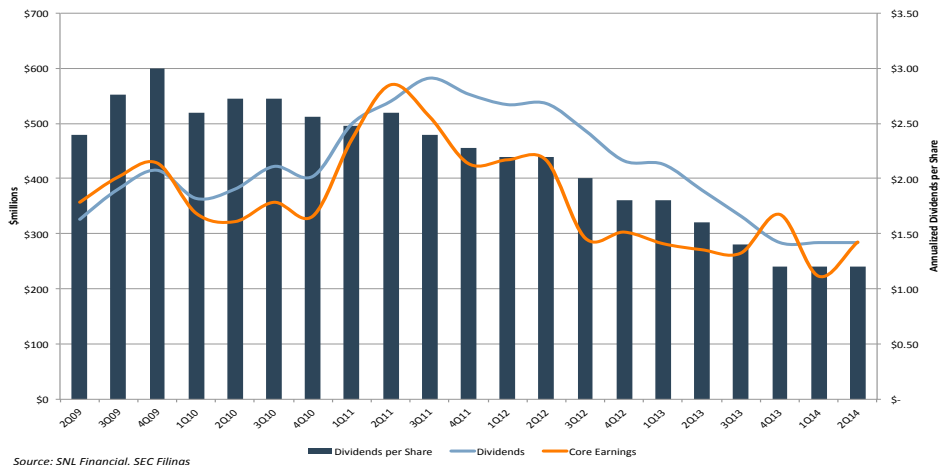
Source: SNL Financial, SEC Filings



Asset yields for NLY were cut in half, from 4.4% to 2.2% between 2009 and 2013 as prepayment rates accelerated in the wake of declining mortgage rates. Mortgage REITs are much more levered than BDCs; the 2.2% erosion in asset yields multiplied into an 11% reduction in core ROE (from 18% to 7%).

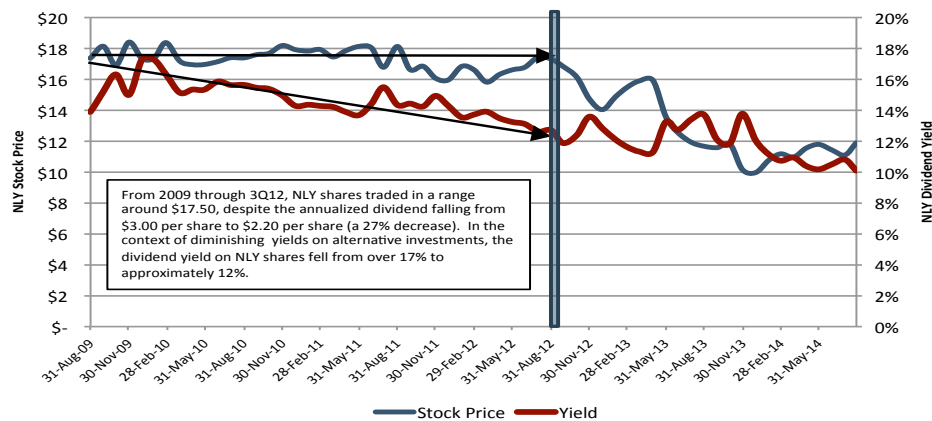
As shown on Chart 2, dividend payments ultimately followed earnings, albeit with a modest lag.

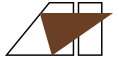
**Chart 2: Core Earnings and Dividends for Annaly Capital Management (NLY)**



Unsurprisingly, the steady drip of dividend cuts eventually dampened enthusiasm for the stock among investors. However, the shares held up for approximately three years, as the same interest rate environment that pressured dividend payouts also reduced yields available on alternative investments. As a result, the share price decline for NLY (and other mortgage REITs) was mitigated by the fact that investors were willing to accept a lower dividend yield. In fact, as shown in Chart 3, NLY share prices oscillated around \$17.50 from the first quarter of 2010 through the third quarter of 2012 despite a 27% cumulative dividend cut over that period.

**Chart 3: Share Price and Dividend Yield for Annaly Capital Management (NLY)**

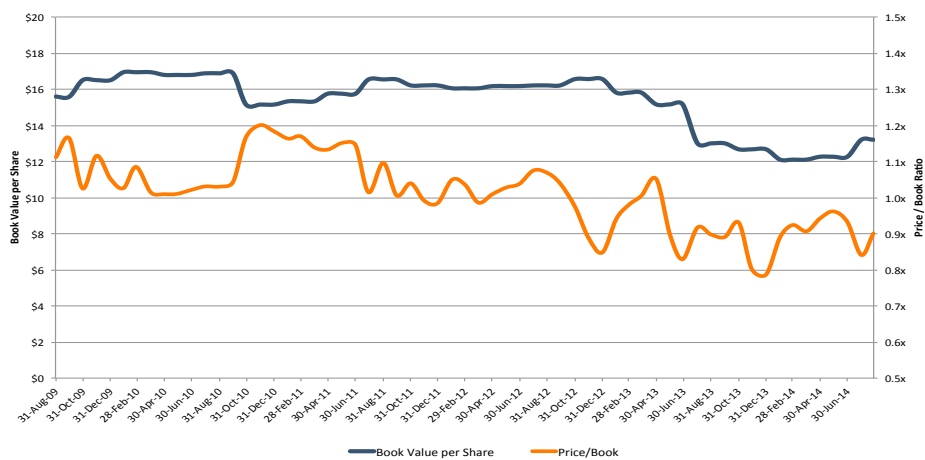




Share price performance deteriorated in 2013, as ten-year treasury yields spiked on concerns about tapering, triggering a \$3.1 billion unrealized loss on NLY's securities portfolio. The portfolio writedown was largely responsible for the erosion in NLY's book value per share from \$15.81 at the end of 2012 to \$12.10 at the end of 2013. In the face of eroding support from book value per share and further dividend cuts, investors bid down NLY shares by 29% during 2013.

Chart 4 summarizes book value per share (and the corresponding price/book ratio) over the period. While price/book ratios have trended below 1.0x, book value per share does exert some gravitational pull on, and support for, stock prices. Since late 2013, share prices for NLY and other mortgage REITs have rebounded amid a rally in treasuries, hopes for stabilizing portfolio yields, and recovery in book value per share.

**Chart 4: Book Value per Share and Price/Book Ratio for Annaly Capital Management (NLY)**



In summary, the NLY stock price essentially held its ground through three years' worth of dividend cuts until losses on the investment portfolio undercut book value per share.

## Conclusion

As mentioned previously, the trends affecting mortgage REITs since 2009 from declining asset yields have been much more extreme than what one would reasonably expect for BDCs, given the less leveraged financial structure of BDCs. Nonetheless, the experience of mortgage REITs is instructive. What conclusions can be drawn for BDCs?

1. The sustained low rate environment is likely to put pressure on net investment income. The two primary levers available to management (operating expenses and financial leverage) can help mitigate the negative effects, but cannot immunize ROE.
2. The pressure on net investment income suggests that – for BDCs as a whole – dividend cuts are likely inevitable.



3. While the announcement of such cuts may well result in temporary market dislocation, share prices will likely prove fairly resilient over the long-term as investors calibrate dividend yield expectations to what is available in the market.
4. Credit quality, rather than asset yield compression, is the more significant issue for investors. While non-performing assets have remained tame through the credit cycle (0.74% of total assets at the end of 2Q14, compared to 1.5-2.0% in 2010), credit performance can be hard to predict. Fair value marks on BDC balance sheets may be the best forward indicators of credit performance available to investors.

Absent an abrupt change in the Fed's zero interest rate policies, lower dividends are likely on the horizon for BDC investors. However, the bigger risk to BDC share prices is likely from credit-related events (primarily realized losses and secondarily credit marks from spread widening) eroding NAV per share, as confirmed by the experience of mortgage REITs in 2013. As a result, investors will presumably scrutinize fair value marks and underlying assumptions more closely to gauge the firmness of NAVs and the potential for future write-downs or dividend cuts from an increase in non-performing assets.



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Travis leads Mercer Capital's Business Development Companies industry team. His practice focuses on providing public and private clients with fair value opinions and related assistance pertaining to goodwill and other intangible assets, stock-based compensation, and illiquid financial assets.

He is a frequent speaker on fair value accounting topics to audiences of financial executives, auditors, and valuation specialists at professional conferences and other events across the U.S. Travis also co-authored the book *Business Valuation: An Integrated Theory, Second Edition*, with Z. Christopher Mercer, ASA, CFA, ABAR (Wiley Finance, 2008).

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