Business Development Companies (BDCs)

Frequently Asked Questions

1. What rules must a BDC follow in order to retain its BDC status?

Typically, a business development company (BDC) makes two elections related to how the company is regulated. One election is for regulated investment company (RIC) status, and a second is for BDC status. These rules are designed to ensure that BDCs are well-capitalized, invest prudently, and distribute their earnings to shareholders.

The regulated investment company election allows a company to act as a pass-through investment vehicle, avoiding double-taxation on income earned. To retain status as a RIC, a company must:

- Pay out at least 90% of taxable income to shareholders in the form of a dividend.
- Derive at least 90% of gross income from investment activities.

In addition to RIC regulations, to retain status as a BDC, a company must:

- Invest at least 70% of their assets in qualifying investments. Qualifying investments include debt securities issued by small- and medium-sized businesses, equity securities of small- and medium-sized businesses, and certain other investments that are designed to promote the growth of small- and medium-sized businesses.
- Maintain a minimum asset coverage ratio of 150%. The asset coverage ratio is a measure of a BDC's financial strength. It is calculated by dividing the BDC's total assets by its total liabilities.
- Hold a diversified portfolio. This rule requires that at least 50% of portfolio assets be comprised of investments which individually represent 5% or less of portfolio assets. In addition, no single investment can exceed 25% of total assets.
- File annual and quarterly reports with the Securities and Exchange Commission (SEC). These reports provide information about the BDC's financial performance, investments, and management.

In addition to these rules, BDCs must also comply with the "Blue Sky Laws" of the states in which they offer their securities. The Blue Sky Laws are state securities laws that are designed to protect investors from fraud.

If a BDC fails to comply with any of the rules for RICs, it may lose its RIC status. This would mean that the BDC would no longer be able to claim the tax benefits that are available to RICs.

2. How diversified are BDC portfolios?

BDC portfolios are generally diversified across a number of factors, including:

- Industry: BDCs invest across a variety of industries, ranging across the spectrum of business-to-business and business-to-consumer companies.
- Loan type: BDCs invest in a variety of loan types, including senior-secured loans, unsecured loans, and mezzanine loans. Different BDCs have different strategies that often focus on different segments of the capital stack.
- Debt vs. equity: BDCs typically invest in a mix of debt and equity securities. Typically, equity represents a small segment of a BDC's portfolio, though this segment offers greater potential for portfolio growth. This helps to further diversify the portfolio and reduce risk.

In addition to these factors, BDCs may also diversify their portfolios by geography and investment strategy, such as a focus on companies of a specific size.

According to a 2022 survey by the National Association of Business Development Companies (NABDC), the average BDC portfolio is diversified across the following industries:

- Technology: 32%
- Healthcare: 24%
- Industrials: 18%
- Financial services: 12%
- Consumer discretionary: 10%

The survey also found that the average BDC portfolio is diversified across the following loan types:

- Secured loans: 64%
- Unsecured loans: 28%
- Mezzanine loans: 8%

3. Do BDCs purchase or originate the loans in their portfolios?

BDCs can both purchase and originate loans in their portfolios.

BDCs can purchase loans from other lenders, such as banks, credit unions, and other BDCs. When purchasing loans, BDCs typically negotiate the terms of the loan with the original lender. BDCs that purchase loans from other lenders typically have access to a wider range of loans. BDCs can also originate loans directly to small and medium-sized businesses. This involves underwriting the loan and then making the loan to the borrower. BDCs that originate loans typically have a team of experienced credit analysts who evaluate the financial strength of the borrower and the risk of the loan. BDCs that originate their own loans typically have more control over the terms of the loan and the borrower.

4. What types of investments does a BDC typically hold in its portfolio?

BDCs typically hold a variety of investments in their portfolios, including:

- Debt securities: BDCs invest in a variety of debt securities, including senior secured loans, subordinated loans, and mezzanine loans. Senior secured loans are the most senior type of debt and have the first claim on the borrower's assets in the event of default. Subordinated loans are less senior than senior secured loans and have a lower priority claim on the borrower's assets in the event of default. Mezzanine loans are in between senior secured loans and subordinated loans in terms of seniority.
- Equity securities: BDCs may also invest in equity securities of small and medium-sized businesses. This is typically done through preferred stock or common stock investments. Preferred stock investors have a higher claim on the company's earnings and assets than common stock investors in the event of liquidation. Common stock investors have the lowest claim on the company's earnings and assets.
- Structured products: BDCs may also invest in structured products, such as credit-linked notes and collateralized loan obligations. Structured products are complex financial instruments that can be used to gain exposure to a variety of different assets, including debt securities, equity securities, and commodities.

The specific types of investments that a BDC holds in its portfolio will vary depending on its investment strategy. Some BDCs focus on direct lending, while others focus on secondary market investing. Some BDCs invest in a mix of debt and equity securities, while others focus on a single asset class. The most common assets held by BDCs are senior secured loans, estimated to be between 55-65% on average. Unsecured loans typically make up 20-30% of BDC investments.

5. What are the typical characteristics of the loans BDCs hold?

BDCs typically hold loans that have the following characteristics:

- Interest rate: BDCs typically invest in loans with floating interest rates. This means that the interest rate on the loan will fluctuate over time based on a benchmark interest rate, such as the Secured Overnight Financing Rate (SOFR).
- Loan size: BDCs typically invest in loans that range in size from $5 million to $100 million.
- Loan maturity: BDCs typically invest in loans that have maturities of 3 to 7 years. Typically, loans are non-amortizing bullet-type loans.
- Loan type: BDCs typically invest in senior secured loans, subordinated loans, and mezzanine loans.
- Borrower credit quality: BDCs typically invest in loans to borrowers with good credit quality. However, some BDCs may invest in loans to borrowers with lower credit quality in order to generate higher returns.

6. What are a BDC's sources of capital?

The primary sources of capital for a BDC are equity and debt. Publicly traded BDCs raise capital through initial public offerings (IPOs), seasoned equity offerings (SEOs), and debt raises through various channels. This capital is used to purchase or originate the BDC's portfolio of loans and other portfolio company financings. BDCs are permanent capital entities, meaning their capital has an unlimited time horizon and is meant to be permanently invested in portfolio companies.

7. How much leverage do BDCs typically employ?

Business development companies (BDCs) typically employ leverage ratios between 1:1 and 2:1, meaning that they have between $1 to $2 of debt for every $1 of equity. For comparison, REITs and banks typical employ leverage of 7:1 and 8:1, respectively, though their underlying assets tend to be less risky.

The amount of leverage that a BDC employs tends to vary depending on its investment strategy. BDCs that employ more leverage have the potential to generate higher returns; however, they also have a higher risk of loss.

8. Are BDCs exposed to pre-payment and/or reinvestment risk?

Yes, BDCs are exposed to pre-payment and reinvestment risk. Reinvestment risk occurs when a loan made to a portfolio company either matures or is repaid early, and the BDC must re-lend the proceeds at a lower interest rate. Loans made by BDCs are generally floating rate loans, which somewhat mitigates these effects; however, declining credit spreads can and do incentivize borrowers to pre-pay their loans which exposes BDCs to reinvestment risk.

BDCs can manage pre-payment risk by structuring their loans with pre-payment penalties. This means that borrowers will have to pay a fee if they repay their loans early.

9. Are BDC share prices impacted by changing interest rates?

Yes, BDC share prices can be impacted by changing interest rates. Because BDCs typically invest in loans with floating interest rates, the income a BDC generates will fluctuate over time based on a benchmark interest rate, such as the Secured Overnight Financing Rate (SOFR). When interest rates rise, the interest income that BDCs generate from their loans will also rise. This leads to higher dividend payments which can be supportive of BDC share prices.

In addition to the impact from benchmark interest rates themselves, BDC share prices also have sensitivity to credit spreads, the amount above a base interest rate that a creditor requires to account for the creditworthiness of a borrower. While some amount of spread is seen as beneficial to a BDC, credit spreads can widen due to general economic concerns. This scenario is generally a headwind to BDC share prices.

In practice, these two interest rate elements – the base rate and the credit spread – have a degree of offsetting effect. Because of this, BDC share prices have historically shown a positive, but muted correlation with interest rates.

10. What is the tax treatment of BDC dividends?

The tax treatment of BDC dividends depends on the type of dividend. BDCs can distribute four types of dividends:

- Ordinary income dividends: These dividends are taxed as ordinary income at the shareholder's tax rate.
- Qualified dividends: These dividends are taxed at a lower rate than ordinary income dividends, typically 15% for most taxpayers. To qualify for the lower tax rate, the dividends must be held for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date.

- Return of capital: This is not a dividend in the traditional sense, but it is a distribution of the shareholder's own investment back to them. Return of capital distributions are not taxed.
- Net investment income (NII) dividends: These dividends are paid by BDCs that invest in certain types of debt securities, such as real estate mortgage investment conduits (REMICs) and collateralized debt obligations (CDOs). NII dividends are taxed as ordinary income at the shareholder's tax rate.

Most BDCs distribute ordinary income dividends and qualified dividends. The percentage of each type of dividend will vary depending on the BDC's investment strategy.

11. How are a BDC's required distributions calculated?

In order to maintain its status as a pass-through entity for taxation purposes, a BDC must pay out at least 90% of its investment company taxable income (ICTI) to shareholders in the form of dividends. The ICTI is broadly calculated by subtracting expenses such as management fees, interest expense, and taxes from the BDC's net investment income (NII). NII is a BDC's income from its investments.

Typically, the primary driver of ICTI comes from the interest income a BDC earns on its debt portfolio. This includes not only cash interest received, but also Paid-in-Kind (PIK) interest. Additionally, net realized capital gains must be included in the calculation, though a net realized capital loss is not deductible against a BDC's ICTI and therefore cannot reduce a BDC's required distribution. Unlike realized gains and losses, unrealized gains and losses do not impact a BDC's required distribution.

12. How does a BDC value the holdings in its portfolio?

How a BDC values its holdings is determined by the FASB's ASC 820. Under ASC 820, a BDC determines the fair value of its holdings using one of three methods:

- Level 1 – Mark-to-market: This method uses price quotations in active markets for identical assets or liabilities as inputs to determine fair value.
- Level 2 – Mark-to-comparable: This method uses price quotations in active markets for similar assets or liabilities as inputs to determine fair value.
- Level 3 – Mark-to-model: This method uses unobservable inputs to determine fair market value. In this method, the BDC creates a model to value a holding, and that model uses inputs that may require management's judgment and estimation.

For most publicly traded BDCs, the vast majority of holdings are valued using the mark-to-model methodology. Due to management's discretion in valuing these holdings, it is important to evaluate a BDC's asset quality.

It is also important to note that a BDC's holdings can change in value over time. Depending on assessments of fair value, a holding's value may increase or decrease, generating an unrealized gain or loss which flows through the BDC's income statement. While unrealized gains and losses impact a BDC's income statement, they do not impact a BDC's distribution requirement.

13. What is the difference between and internally- and externally-managed BDC?

The main difference between an internally managed and an externally managed BDC is who makes the investment decisions.

Internally managed BDCs have their own investment team that makes all of the investment decisions. This team typically consists of experienced investment professionals with a deep understanding of the small and medium-sized business market.

Externally managed BDCs outsource their investment management to a third-party investment advisor. This advisor is responsible for making all of the investment decisions on behalf of the BDC.

Each type of BDC has its own advantages and disadvantages.

Internally managed BDCs offer advantages including better alignment of interest with shareholders, better transparency and greater portfolio flexibility. Disadvantages can include high portfolio complexity and sometimes higher valuations in the market.

Advantages of externally managed BDCs can include simplicity and the expertise of the investment advisor hired to manage the portfolio. Disadvantages can include potential conflicts of interest and less transparency than internally managed BDCs.

14. What fees do BDCs charge?

BDCs typically charge two types of fees: management fees and incentive fees.

Management fees are paid to the BDC's investment advisor on a regular basis, typically quarterly. Management fees are typically a percentage of the BDC's assets under management, ranging from 1%-2%.

Incentive fees are paid to the BDC's investment advisor if the BDC performs well. Incentive fees are typically a percentage of the BDC's profits, ranging from 0% -20%.

15. How do the Acquired Fund Fees and Expenses (AFFE) rules impact BDCs?

The SEC's AFFE rules require that a regulated investment company (RIC) that owns another RIC (e.g., a mutual fund owning a BDC) must reflect the owned RIC's operating expenses in calculated expense ratios. In simple terms, if a mutual fund owns a BDC, the mutual fund must reflect the BDC's costs of operations in the expense ratio of the mutual fund. As a result of the negative impact on fees, mutual funds are averse to owning BDCs.

Additionally, AFFE rules prohibit any RIC from owning more than 3% of another RIC. If, for example, an index had a position larger than 3% in a given BDC, an index fund tracking that benchmark would be unable to own the appropriate weight. Because of this rule, major index providers have chosen to exclude BDCs from their indices.

Combined, these rules have limited institutional ownership in the BDC space.

16. Why are BDC expense ratios so high?

BDC published expense ratios look expensive when compared with other RICs or pooled investment vehicles. Some BDCs may show expense ratios from 6% to 12% of assets managed when compared to less than 2% for most mutual funds or closed end funds. The reason is that a BDC is more comparable to a bank or private equity fund where the management of the fund is responsible for sourcing, structuring, negotiating the terms of investment deals as well as the legal and regulatory costs of closing investments. Most other pooled investment vehicles merely purchase or sell investments that have already been created by others who bear those fees. As such, the expense ratio of a BDC is perhaps more comparable to the cost to income ratio for a bank or other financial intermediary. Banks typically post cost ratios in the range of 50% of net investment income, which is greater than the expense ratio recorded by BDCs.

Notably as BDCs have started to face more competition for funds, the management fees and incentive costs have started to trend down over time. The typical management fee for a new BDC has come down from 2.00% to between 1.75% and 1.50% and incentive fees increasingly have begun to net capital losses against income in their calculation.