SHOULD BDCs BE PART OF THE INVESTMENT CONVERSATION?

OVERVIEW

In our work as a family office company, families often ask us questions about specific investment vehicles, particularly when those investment vehicles begin to gain the attention of the financial media. Over the past few weeks, business development companies (BDCs) have been part of those conversations. But what are BDCs? And more importantly, should a family consider BDCs as part of their asset allocation mix? To help answer questions on BDCs, we've drafted this brief primer to provide some essential information.

First, a little bit of background. Created by the Small Business Investment Incentive Act of 1980 as a result of a perceived crisis in the capital markets in the 1970s, BDCs are a special type of closed-end fund designed to provide small, growing companies access to capital, while also enabling private equity funds to access the public capital markets. From the investor's perspective, BDCs can perform as an alternative to fixed income investments, particularly in a low interest rate environment where real rates are essentially at zero.

A hybrid between an operating company and an investment company, BDCs provide private, continuous offering to accredited investors. Investors can choose between "Private BDCs," "Non-Listed BDCs," and "Listed BDCs."

ADVANTAGES

Ultimately, the question families often ask us is whether or not to consider these little-known investments, particularly at a time when bond yields in traditional credit markets remain unattractive. Effectively, because BDCs serve as fixed income alternatives in a low-interest rate environment and they can offer essential diversification from traditional asset classes, BDCs can help soften market volatility by lowering potential drawdown risk.

- Some private BDCs offer attractive quarterly cash distributions in a semi-liquid vehicle.
- High-yield spreads are with ~50bps of pre-COVID-19 levels. However, with record downgrades in traditional credit and elevated leverage, there could be hidden risks for spread widening.
- Some private credit BDCs offer low to negative correlation with traditional asset classes producing portfolio diversification benefits.
- Private BDCs are less volatile when compared to public BDCs or traditional fixed income.
- A BDC is a very efficient tax-blocker (blocks ECI and UBTI) for non-US and US tax-exempt investors.
- BDCs receive enhanced regulatory oversight and 40 Act reporting compared to traditional private credit vehicles.
- No requirement for K-1 filing for investors.

CONSIDERATIONS

The Manager is not required to grant liquidity to investors, so the investment could potentially be illiquid. Managers generally make a commercially reasonable effort to meet redemption requests using cash reserves, subscriptions, leverage facilities, secondary market or IPO. However, liquidity is not guaranteed.

TAXATION

BDCs are a corporation for US federal income tax purposes but pay no entity-level tax. Generally, most BDCs elect to be taxed as a Regulated Investment Company (RIC), and as a RIC, the BDC must distribute over 90% of its profits to shareholders, but it does NOT pay corporate income tax on profits.

Income distributed by the BDC is characterized and taxed as follows:

- DIVIDEND INCOME: Includes all distributions paid from a fund's NET INVESTMENT INCOME (generally, interest, dividends, and securities lending income LESS fund expenses) AND net realized short-term capital gains. The applicable rate of income tax is passed through the fund to the US shareholder.
    - Qualified Dividend Tax Rate (current combined gross rate 23.8%) applies on qualified dividends realized by the fund (NOTE that it is unlikely that a BDC would have any material amount of QDI distributions).
    - Ordinary Dividend Tax Rate (37%) applies to all other income, including underlying qualified dividend income if the fund subscriber has held the shares of the fund for less than 61 days before or after the ex-dividend date.
- LONG-TERM CAPITAL GAIN INCOME: Includes all distributions paid from a fund's NET long-term capital gains. The applicable current combined gross tax rate is 23.8% regardless of how long the shareholder has held shares in the fund.
- FOREIGN TAX CREDITS: If a fund has more than 50% of the value of its assets invested in stock or securities of foreign corporations at the end of its tax year, the fund MAY ELECT to pass through to its shareholders the ability to take, subject to certain limitations, either a foreign tax credit or a deduction with respect to the foreign withholding taxes paid by the fund.

REGULATORY REQUIREMENTS

BDCs are regulated as an investment company, but to a lesser extent as provided by Sections 55-65 of the 1940 Act, and they:

- Must offer to provide managerial assistance to portfolio companies;
- Must have majority-independent board of directors;
- Must value assets at least quarterly;
- Must maintain 200% asset coverage ratio (1:1 assets to leverage);
- Must appoint a chief compliance officer (who reports to the board) and maintain compliance procedures designed to prevent violations of federal securities laws;

- Must adopt of code of ethics that requires reporting requirements of investment personnel;
- Must maintain a fidelity bond to protect the BDC against larceny and embezzlement;
- Must invest at least 70% of its total assets in "qualifying assets." This requires investments in US private operating companies with a market cap <$250m;
- Must ensure all securities be held by a custodian that meets requirements under the 1940 Act; and
- All BDCs and their investment advisers subject to regulatory exams by the SEC.

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