KARPUS INVESTMENT MANAGEMENT

COMMENTARY

June 2022

A Primer on Debt Issued by Business Development Companies

When the Federal Reserve cut the Federal Funds Effective rate to 0%-0.25% in 2009, the fixed income market entered into over a decade long period of ultra-low interest rates. In fact, during the last ten years, the 10-year U.S. Treasury had an average yield of 2.04%, compared to the 1990s when the average was 6.56%.

The ultra-low interest rate environment created a challenge of either: (a) favoring capital preservation but accepting almost no yield, or (b) moving up a risk tranche to satisfy the yields needs but risking capital that could result in heavy losses if interest rates moved up.

Low rates for such a long period of time therefore created an unprecedent challenge for those tasked with fixed income investing: where to find attractive yield without taking on excess risk.

One investment we found and continue to find attractive are preferred shares and senior notes issued by Business Development Companies (BDCs). A BDC is a type of closed-end investment company that invests in smaller, private companies via long-term loans and equity investments. BDCs were created by the Small Business Investment Incentive Act of 1980 (which resulted in an amendment that added the newly created BDCs to be covered under the Investment Company Act of 1940 (the "1940 Act")).

BDCs issue debt in the form of senior notes and preferred shares to leverage their portfolio and to be able to invest in more companies. The senior notes and preferred shares generally have a par value of $25 and typically have a maturity date within 5-10 years of being issued (although occasionally a BDC will issue a perpetual preferred share that will only cease to exist when the fund closes or the fund calls the share).

We believe that preferred shares and senior notes of BDCs can be a good investment for an investment portfolio currently targeting the 2-7 year range on the yield curve.

The majority of BDC preferred shares and senior notes are rated investment grade, with a typical rating of BBB-. In addition, we feel that many individual BDC senior notes or preferred shares offer an attractive yield compared to other BBB fixed income debt. For instance, as of 6/7/2022 the 5 Year BBB Corporate Bond Composite was yielding 4.31%. By comparison, the average yield on a senior note/preferred share issued off a BDC is 5.83% and has an average maturity of approximately 4 years and 4 months.[1]

In addition to the yield advantage outlined above, BDC shareholders enjoy asset coverage protections afforded to them under the 1940 ACT. What this means is that a BDC's debt cannot exceed statutorily prescribed limits in relation to its equity. Simply put, an asset coverage ratio is a company's assets divided by total debt. For a BDC, the total debt would be comprised of debt issued for leverage in the form of senior notes and preferred shares.

Until 2018, this statutory ratio was 200%; meaning that for every dollar of debt the BDC had to maintain at least two dollars of assets. In March 23, 2018, Congress allowed for BDCs to elect to decrease their asset coverage from 200% to 150% via the Small Business Credit Availability Act (provided that certain disclosure and approval requirements are met). Some BDCs have elected to remain at 200% asset coverage ratio while others have received the requisite approvals and decreased their asset ratio to 150%.

Asset coverage ratios are important because of the protection they offer shareholders of BDCs when these asset coverage ratios are breached. In the case the asset coverage falls below a BDC's statutory level, the BDC is prohibited from making any dividend payments or distributions to equity shareholders until the asset coverage is restored to the minimum ratio.

The 1940 Act also states that the senior notes/preferred shares have "…complete priority over any other class as to distribution of assets and payment of dividends, which dividends shall be cumulative." This protection ensures the senior notes/preferred shareholders get priority and must be made whole in the event a BDC experiences financial trouble before any other shareholders can be paid.

For other Karpus insights, please see our website.

Sources: BDC Reporter, Bloomberg Finance, L.P., Dechert.com, Franklin Templeton, Morningstar, The Investment Company Act of 1940.

1. The list of available senior notes was gathered from BDC Reporter on 6/7/2022. The average yield and average maturity were then calculated using data from Bloomberg Finance, L.P. for each senior note on the aforementioned list.

Important Notice

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