# Deep Dive into BDCs: How to Invest in Growing Businesses

**June 2024**

**Investing in Business Development Companies (BDCs) provides investors with the potential for income alpha and lower volatility compared to traditional fixed income. Because of their exposure to private markets, BDCs can potentially increase portfolio diversification and reduce overall portfolio risk.**

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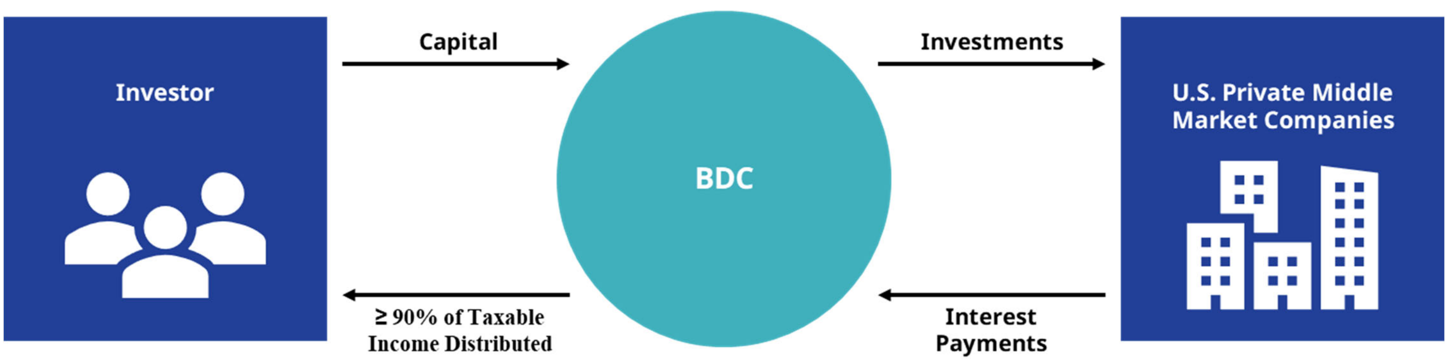
At PennantPark, our mission is to serve as a trusted partner for our investors, borrowers, and middle market private equity sponsors. A key pillar of this mission is our expertise in BDCs. But what exactly are BDCs, and how can they benefit investors?

### What is a BDC?

BDCs are regulated investment companies that play a vital role in fueling the American economy by providing an alternative source of funding for small and medium-sized private businesses. These businesses often struggle to secure traditional bank loans or public financing, hindering their growth potential. BDCs step in to bridge this gap by investing in these businesses, typically through debt financing with equity participation in some cases, similar to how REITs invest in real estate.

To ensure responsible investment practices and mitigate risks, BDCs are subject to leverage limits mandated by the Investment Company Act of 1940. By regulation, BDCs must have a 200% asset coverage[1].This safeguard prevents BDC managers from taking on excessive debt that could jeopardize both the BDC's financial health and the funded businesses.




### Potential Benefits for Investors

Investors could stand to benefit from the potential for attractive risk-adjusted returns, as BDCs typically invest in growing businesses with strong cash flows, offering the potential for higher returns than

[1] BDCs asset coverages are used to ensure that these entities have sufficient assets to cover their liabilities and obligations to shareholders. Asset coverages are typically calculated by dividing total assets by its outstanding senior securities.

traditional fixed income. In addition, BDCs provide exposure to private markets, which increases portfolio diversification and can potentially reduce overall portfolio risk. Lastly, BDCs are tax advantageous as they are pass-through entities with 1099 tax reporting.

**Understanding BDC Types**

PennantPark has historically specialized in managing publicly traded BDCs, such as NYSE: PNNT, launched in 2007, NYSE: PFLT, launched in 2011, and is currently in the process of registering and launching a private, perpetual BDC.

Below are the different types of BDCs available in the broader market:

<table>
<tr><th colspan="5">Types of Business Development Companies (BDCs)</th></tr>
<tr><th colspan="2"></th><th>Public</th><th>Private</th><th>Non-Traded</th></tr>
<tr><td colspan="2">Offering</td><td>IPO or secondary offerings</td><td>Monthly subscriptions</td><td>Monthly subscriptions</td></tr>
<tr><td colspan="2">Investor Eligibility</td><td>Open to public</td><td>Accredited Investors[2]</td><td>Accredited Investors[2]</td></tr>
<tr><td rowspan="2">Blue Sky Laws</td><td>Financial Advisor Compensation Limits</td><td>No</td><td>No</td><td>Yes, 10%</td></tr>
<tr><td>Investor Liquid Net Worth Restrictions</td><td>No</td><td>No</td><td>Yes, 10%</td></tr>
<tr><td colspan="2">NAV Frequency</td><td>Quarterly</td><td>Quarterly</td><td>Monthly/quarterly</td></tr>
<tr><td colspan="2">Liquidity</td><td>Daily</td><td>Quarterly</td><td>Quarterly</td></tr>
<tr><td colspan="2">Price Volatility</td><td>Greater</td><td>Lower</td><td>Lower</td></tr>
<tr><td colspan="2">Leverage</td><td>Max 2.0x Debt/Equity</td><td>Max 2.0x Debt/Equity</td><td>Max 2.0x Debt/Equity</td></tr>
<tr><td colspan="2">Tax Reporting</td><td>1099</td><td>1099</td><td>1099</td></tr>
</table>

- **Publicly traded BDCs**: These BDCs provide retail investors with access to private markets while trading on stock exchanges, offering greater liquidity and wider accessibility. However, these BDCs could be subject to daily price volatility not experienced by private or non-traded BDCs.
- **Private BDCs:** These BDCs are suitable for Accredited Investors[2] and institutional investors with a longer investment horizon, aiming to potentially capture higher yields and have the option to exit through quarterly redemptions.
- **Non-Traded BDCs:** Similar to private BDCs, Non-traded BDCs are suitable for Accredited Investors[2] and institutional investors with the main difference being that these are subject to

[2] An Accredited Investor is defined as an individual with: (i) earnings over $200,000 (individually) or $300,000 (with spouse or partner) in each of the last two years and expects the same for the current year, (ii) having a net worth over $1 million excluding primary residence.

Blue Sky Laws, resulting in restrictions on client exposure and financial advisor's compensation limits in many states.

From a regulatory standpoint, all BDCs must file periodic SEC reports, such as Forms 10-K and 10-Q, and comply with the Sarbanes-Oxley Act of 2002. Additionally, from a tax perspective, BDCs must comply with regulations that require at least 90% of their taxable income to be distributed to shareholders via dividends in order to avoid corporate taxes.

**Choosing the Right BDC**

When choosing a BDC, it is crucial to consider both the type of vehicle and the expertise of the manager to help ensure your investment goals are met and risks are minimized. Conduct thorough due diligence on the investment manager, prioritizing those with a proven track record through various market cycles, including the Global Financial Crisis and the COVID-19 pandemic.

Additionally, be vigilant about managers who exhibit inconsistent net interest income ("NII") distributions, high levels of non-accruals, elevated leverage, and significant exposure to paid-in-kind (PIK) loans, as these factors may indicate deteriorating credit quality and attempts to conceal problematic assets.

**Can IRAs Invest in BDCs?**

Yes. Individual Retirement Accounts (IRAs) can invest in BDCs. However, as stated above, careful manager selection is crucial due to potential risks involved with BDC investments.

**We welcome a conversation; please contact invest@pennantpark.com or the professionals listed below.**

# Contact Us

## About PennantPark:

PennantPark is an independent middle market credit platform founded in 2007 by private credit industry veteran Art Penn (Co-Founder and former Managing Partner at Apollo Credit). As of 2024, PennantPark has invested over $20 billion in over 730 private credit transactions since its inception. Our clients include some of the world's largest and most sophisticated institutional investors. We are in the process of expanding our offerings to focus on the private wealth market. The Firm is headquartered in Miami and has additional offices in New York, Chicago, Houston, Los Angeles, and Amsterdam. PennantPark primarily invests in the core middle market, defined as companies with earnings of $10 million to $50 million. Our industries of focus include business services, government services, healthcare, consumer, and software/technology. PennantPark offers investment strategies through various public and private fund structures, including BDCs, LP drawdown vehicles, CLOs, SMAs, and joint ventures.

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