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BDC equities: Well-positioned for a soft landing

We believe business development companies offer an attractive option for portfolio diversification. Historically, they have had low correlation to yield-oriented asset classes and are well positioned for varying interest-rate environments.

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The notion that the United States can avoid a recession has gained traction as recent economic data shows the economy still growing. While certain indicators, notably employment and manufacturing activity, have softened, the economy has maintained its positive momentum on the back of resilient consumer spending.

A so-called soft landing would be positive for business development companies (BDCs). BDCs provide financing to midsize private companies. An expanding economy would enable borrowers to stay current on their obligations and keep problem loans to a manageable level. Because BDCs don't need the economy to thrive, even slow gross domestic product (GDP) growth would be sufficient to maintain good BDC returns. To this point, public BDC credit performance has remained benign, as the median public BDC net asset value for the third quarter declined by only 0.35% versus the previous quarter, and median BDC non-accrual rates, a measure of stressed borrowers, declined by 9 basis points (bps) during the quarter.[1]

Also, data from BDCs' middle market portfolio companies confirmed that these enterprises are generally navigating the choppy economy well. The Golub Capital Altman Index of approximately 150 middle market businesses showed year-over-year revenue and EBITDA (earnings before interest, taxes, depreciation and amortization) up 5.1% and 7.9% respectively through August 2023.

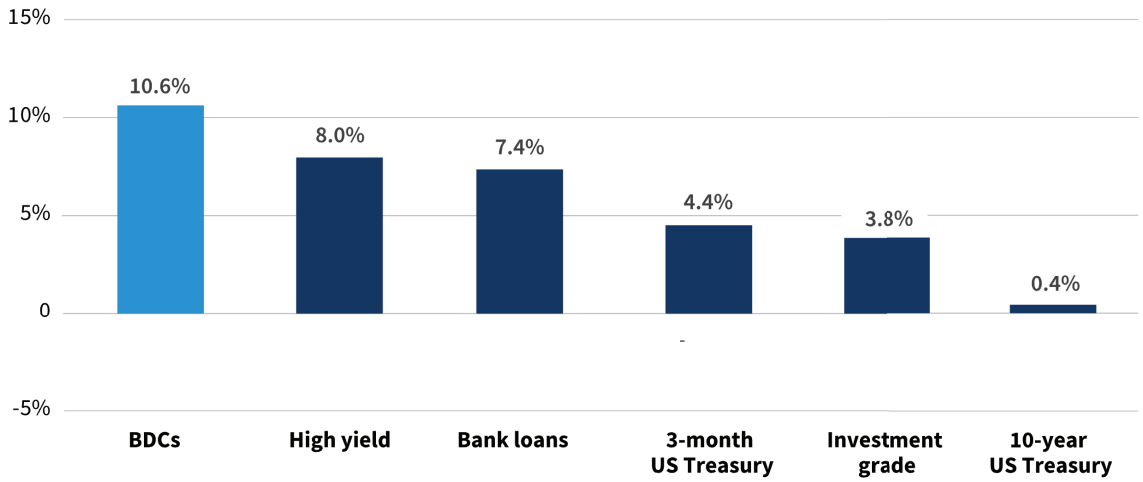
Less aggressive Fed could preserve BDC earnings strength

A non-recessionary economy would also reduce pressure on the Federal Reserve (Fed) to aggressively cut rates, which should help keep BDC earnings and dividends close to their current high levels. Expectations for Fed rate cuts changed considerably throughout 2024 as the market digested GDP and inflation data. In mid-January 2024, the federal funds futures markets priced in more than six 25-basis-point interest-rate cuts by year-end. However, by April, markets had dramatically reduced expectations—to only a single 25-basis-point cut. As of mid-November, the futures markets reverted a bit, embedding one more quarter-point cut in December, or 100 bps in total for the year and from the peak federal funds level.

Most loans originated by BDCs are floating rate, so the current elevated interest-rate level, while not quite as high as it was before the September and November 2024 cuts, contributes directly to strong BDC investment income. With their high current yield, BDCs have been a top performer among income-producing asset classes this year. The S&P BDC Index generated a total return of 10.6% through October 31, with the bulk of the return coming from dividends.

BDCs are the Best Income-Producing Asset Class Year to Date

Total returns for income-producing asset classes, 1/2/24 — 10/31/24



Sources: The S&P BDC Index, ICE BofA U.S. High Yield Index, The S&P/LSTA Leveraged Loan Index, ICE BofA 3-Month US Treasury Bill Index, ICE BofA US Corporate Index, ICE BofA Current 10-Year US Treasury Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.**

How will BDCs fare with additional rate cuts?

It is natural to ask what will happen to BDC earnings and dividends in response to further Fed rate cuts. While BDC dividends are up meaningfully since the Fed cycle started, BDCs recognize the sensitivity of their earnings streams to rates and therefore have not increased their dividend payouts as much as they have grown their earnings.

Our research indicates that, on average, base rates could decline by 200 bps from 2024's peak and most BDCs would still cover their full regular dividends with investment earnings. In addition, a decline in rates would likely spur higher loan origination, which would contribute additional fee income to BDCs, further supporting current dividends.

We continue to believe **BDCs offer an attractive option for portfolio diversification**. Historically, they have had low correlation to yield-oriented asset classes.

Also, after multiple quarters of dividend payout ratios being less than 100% of earnings, BDCs have built up substantial "spillover" income that could be used to pay dividends. In many cases, this spillover income can total close to three quarters worth of earnings, offering a significant potential cushion.

A number of BDCs have chosen to augment their regular dividends with smaller supplemental quarterly dividends to distribute some of their increased earnings to investors. These typically have boosted annual dividends by 10% to 15%.[2] Given that rates will likely be cut by 100 bps below peak by year-end, we expect these supplemental dividends will be partially reduced. If rates were to decline by a total of 200 basis points from the peak, we would expect most BDCs to entirely eliminate their supplemental dividends while still maintaining their regular dividends. In this scenario, we would expect BDC total dividends—both regular and supplemental—to be about 85% of their peak levels.

BDCs still offer attractive yields, but active management is key

In these potential rate-cutting scenarios, we believe BDCs would still offer an attractive level of current income, especially when considering that other income-producing asset classes would also feel the impact of rate cuts.

We are starting to see some differentiation in credit performance among the BDCs. **This is a time where active management can be a benefit.**

The higher rate and inflation environment has put stress on some businesses, and we are starting to see some differentiation in credit performance among the BDCs. This is a time where active management can be a benefit, with the flexibility to focus on BDCs that are expected to continue to show good credit results. Similarly, active managers can steer the portfolio toward those BDCs that can better sustain strong dividends as interest rates are cut.

We continue to believe BDCs offer an attractive option for portfolio diversification. Historically, they have had low correlation to yield-oriented asset classes and are well positioned for varying interest-rate environments.

Endnotes

1 Source: BDC analysis from Raymond James, as of 11/15/24.
2 Sources: Bloomberg, Putnam research, as of 11/15/24.

Index Definitions

The S&P BDC Index is designed to track leading business development companies that trade on major US exchanges.

The S&P/LSTA Leveraged Loan Index is a market value-weighted index that tracks the performance of institutional leveraged loans. It's a common benchmark that's updated daily to provide insights into market trends and movements. The LLI is based on data on loan prices, spreads, and other key metrics.

ICE BofA 3-Month US Treasury Bill Index is an unmanaged index that comprises a single US Treasury issue with approximately three months to final maturity, purchased at the beginning of each month and held for one full month.

ICE BofA Current 10-Year US Treasury Index is a one-security index comprised of the most recently issued 10-year US Treasury note.

ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

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Equity securities are subject to price fluctuation and possible loss of principal. **Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks. **Large-capitalization** companies may fall out of favor with investors based on market and economic conditions.

Business development companies (BDCs) generally invest in less mature US private companies or thinly traded US public companies, which involves greater risk than well-established publicly traded companies.

The use of leverage by BDCs magnifies gains and losses on amounts invested and increases the risks associated with investing in BDCs. A BDC may make investments with greater risk of volatility and loss of principal than other investment options and may also be highly speculative and aggressive. Certain BDCs may also be difficult to value since many of the assets of BDCs do not have readily ascertainable market values.

Active management does not ensure gains or protect against market declines.

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