EXPERT Q&A

As demand for floating rate assets increases, investment discipline and a wide frame of reference will prove key, says chief financial officer at Barings BDC, Jonathan Bock

BDCs built for the future

Q As we move towards a higher interest rate environment, we can assume that demand for floating rate assets is going to increase. Given tight spreads and high levels of leverage, how should managers approach that evolving competitive environment?

A Credit discipline is critical when there is a high level of demand for a particular type of asset. As rates do rise, spreads will effectively be compressed, and managers will compete on leverage, price and terms. Increased demand and finite supply tend to bring with them a high level of degradation so, number one, I would stay stick to your knitting.

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It is also helpful to have broad investment parameters as markets become more competitive. Some managers will focus purely on large, upper mid-market direct lending transactions, but often that is where competition is at its most intense. We choose to go wide. There are a number of asset classes that sit inside of private credit, be it asset-based lending or certain types of investments that go beneath the asset value, that can provide strong risk-adjusted returns and that are great complements to a standard mid-market loan. Having that wider frame of reference is beneficial in a competitive environment, compared with a focus on deploying the largest possible amount of dollars.

Q Unusually in the BDC market, you have a European focus. Why is a European allocation attractive?

A We want to seek illiquidity and complexity premiums wherever they reside. Barings is a large global platform and the BDC structure does allow for a level of European investment. We believe that having a European allocation is an attractive diversifier of returns. Just think about how different nations dealt with the covid crisis, for example. Some

recovered faster than others. Having a direct origination team with boots on the ground in Europe can offer a great expansion of risk-adjusted return and we see Europe as a complementary part of the direct lending and illiquidity premium landscape that we target.

Q What are the most attractive sectors from a BDC perspective, and which are best avoided?

A Let me start with what we avoid. Fashion is not an industry you will see us allocating a lot of dollars to. Indeed, any highly commoditised or hyper-cyclical industry, is not going to be somewhere we invest a lot of capital because there is little room for differentiation for the underlying business propositions or even when it comes to lending. What we do like are businesses with a strong reason to exist and recurring cashflows, which can often be found in the software, precision manufacturing and logistics industries, for example.

Q How should investors differentiate between BDCs?

A First off, I would say that how you raise capital dictates how you invest it. If you are consistently raising billions of dollars, you are likely to be less disciplined about how it is deployed. If I give my nine-year-old daughter $5 to buy candy, she isn't going to return any of that money because she is considering the value proposition. Every last cent will be spent. The same is true in private markets. Often, the more money is raised, the more there is a rush to get it deployed and the more returns will ultimately suffer. Incentive structures are also important. Investors should consider how well the BDC is aligned to perform in its shareholders' interests. Finally, I would return to my point about a wide frame of reference. We choose not to anchor ourselves to any one type of investment. That is an important differentiator.

Q Do you think we will see further consolidation of the BDC market?

A As someone who has participated in two, large, combination transactions I do expect there to be a level of continued consolidation, albeit consolidation that makes sense for investors and not for managers. There are a number of BDCs that lack the scale needed to access unsecured markets, something that gives BDCs a higher degree of staying power, so I do believe that more consolidation will take place.

Q How has leverage reform impacted the BDC industry?

A Managers were previously operating at between 0.75x and 0.95x leverage. Now most are operating at between 1x and 1.25x leverage. So, people haven't levered themselves to the gills. You also have to consider the resilience that comes as a result of having more cushion against your test. If you are at 0.75x or 0.85x and your test is 1:1, that is very different to being at between 1x and 1.25x, with a test at 2x. When there is a market dislocation and book values fall, you won't find BDCs running afoul of their leverage tests as we saw during the financial crisis and that is a very good thing for investors. If anything, the resilience of the BDC model has been enhanced.

Q How do you expect the BDC market to fare given a macro backdrop characterised by inflation, on the one hand, and of course now conflict in the Ukraine?

A When capital is scarce, BDCs can execute transactions at better spreads and better terms. But that's not happening. The situation unfolding in the Ukraine is tragic. But setting aside the impact of that conflict on the fear index that exists inside markets, the supply of capital is not being affected so the impact has been limited. Meanwhile, although there are a number of businesses with

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an inherent underlying fragility where an increase in input costs could put pressures on EBITDA, as long as they have been underwritten correctly, in the past one to two years, then those loans are likely to be inflation protected. That said, inflation brings with it rising rates, which brings us back to increased demand for floating assets, leading managers to compete on spread and terms as well as leverage.

Overall, I would expect pretty strong performance over the next five years, even with inflation and even if interest rates rise. The question marks will arise around investments made in years two or three, when the Federal Reserve represents a bigger part of your risk adjusted return. We saw that with covid, when the Fed dropped the floor, meaning some could no longer afford their dividends. The decisions you make today will be the decisions that affect performance five years from now.

Q What do you think the future holds for the BDC market?

A I think the BDC market will continue to grow. Since I have been active in the industry, it has skyrocketed to over $100 billion. I don't see that growth letting up. And as that capital formation increases, a number of tangential markets will begin to pay greater attention to the BDC space, making it a very strong investment proposition over time. ■