BDCs VERSUS TRADITIONAL CLOSED-END FUNDS: HOW THEY STACK UP

FIFTHSTREET

Thanks to attractive levels of income and distinctive market exposure, publicly-traded business development companies ("BDCs") are branching out beyond their traditional institutional investor base to gain a foothold among mainstream investors.

Not only do they provide access to an alternative asset class—mainly debt investments in growing small and mid-sized private U.S. businesses—they also avoid the high investment minimums and stringent lock-ups that private limited partnerships usually require.

Comparisons to closed-end high yield bond and leveraged loan funds most readily spring to mind when positioning BDCs within an overall portfolio. At their most basic level, both are closed-end investments governed by the Investment Company Act of 1940 that have the potential to offer higher yields than more conventional income-oriented strategies. Like traditional closed-end funds, BDCs usually elect to be treated as regulated investment companies (RICs), meaning they bypass corporate income taxes as long as they distribute at least 90% of taxable annual net income to shareholders. However, several subtle differences help explain why BDCs are best viewed as complements, rather than competition, to their high yield bond and leveraged loan fund counterparts.

WHERE BDCS DIVERGE FROM TRADITIONAL CLOSED-END FUNDS

For starters, unlike traditional closed-end funds, which generally favor investments in larger companies that tend to disclose financial and other information with the SEC, BDCs primarily invest in debt of private small and mid-sized companies. BDCs can earn higher yields lending to these businesses because there are fewer lenders in this segment of the market. While this debt may be less liquid than a debt investment in a larger company, the underwriting standards and protections built into the loan are generally stronger, reducing the level of credit risk. The net result is that dividend yields for BDCs are generally in the range of 8% - 12%—materially above yields offered by traditional closed-end funds. For instance, the current yield for the iShares iBoxx USD High Yield Corporate Bond ETF is 5.7%, while the PowerShares Senior Loan Portfolio ETF's is 4.2%.[1] High yield investors who do not feel adequately compensated for the level of assumed risk may want to add exposure to BDCs in order to enhance their portfolios' risk/return profile.

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BDCs are also attractive to investors wishing to diversify their interest rate exposure. Unlike high yield bonds, which typically carry fixed interest rates, many BDCs' underlying portfolios consist of floating-rate securities. In fact, the current industry average of floating rate securities is roughly 60% of total assets,[2] though certain BDCs, like Fifth Street Senior Floating Rate Corp. (NASDAQ:FSFR) ("FSFR"), invest in them almost exclusively. These BDCs are lending at rates that will increase when short-term interest rates climb, so they stand to profit from a rising rate environment.

ORIGINATION PLATFORM OR BUYING IN SECONDARY MARKET?

The entire BDC industry is also benefiting from a changing competitive landscape. After multiple years of industry consolidation as well as a tougher regulatory environment that has raised the costs of financing small and mid-sized private businesses, fewer banks are lending to this segment. As banks retreat, alternative lenders like BDCs have stepped in, emerging as a conduit of capital to these private businesses.

BDCs with access to an origination platform are at the forefront of the shift away from banks. Because they are sourcing, structuring and underwriting investments directly with borrowers, these BDCs are able to better understand the

(1) As of 4/7/14. | (2) As of 12/31/13; Source: The Wells Fargo Q2 2014 BDC Scorecard.

borrowers' businesses when structuring loans. The closer relationship helps to reduce credit risk for the BDC and can generate additional fee income—on top of the coupon amount—as well as a potential discount on the loan.

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Banks have not completely abandoned this market segment, though. They often finance the BDCs, who in turn lend to small and mid-sized private companies. This means BDCs are able to borrow from banks at relatively low costs—especially in the case of BDCs with investment grade credit ratings—while lending at higher rates. In contrast, many traditional closed-end funds and BDCs without an origination platform either purchase their assets in the secondary market or from other lenders. Being further from the point of origination reduces the amount of fee income as well as any potential loan discounts.

OTHER POINTS OF COMPARISON

When selectively adding BDC exposure, there are some important factors to bear in mind. First, only a handful of BDCs, including Fifth Street Finance Corp. (NASDAQ:FSC) ("FSC") and FSFR, are affiliated with leading origination platforms. As mentioned previously, BDCs with access to an origination platform generally take a more active role in structuring transactions, capturing benefits that are largely unavailable to investors without an origination platform.

Second, BDCs generally operate with leverage of up to 1x debt-to-equity versus the regulatory leverage of 0.33x debt-to-equity that typically applies to traditional closed-end funds. Traditional closed-end funds use both structural and portfolio leverage, with the latter including certain types of derivatives, reverse repurchase agreements and tender-option bonds.

In contrast, larger BDCs—especially those with an investment grade credit rating— generally have greater diversity in their capital structure and do not utilize derivatives for leverage. For example, FSC has two bank credit facilities with different costs, terms and maturities, secured debt provided by the Small Business Administration, as well as several different tranches of unsecured debt. The diverse funding sources for larger BDCs like FSC help efficiently fund different types of investments while managing interest rate and liquidity risk.

Third, BDCs are required to offer managerial assistance to their borrowers, and many times can attend the board meetings for their borrowers or have outright seats on the board. This is different than most high yield bond and leveraged loan investors who are mainly passive investors, unless the borrower is distressed.

Finally, BDCs generally disclose more in-depth information more frequently than traditional closed-end funds. SEC oversight mandates transparent reporting from both; however, BDCs file annual and quarterly reports with the SEC that include a detailed schedule of investments and a discussion of the results. Some BDCs also host quarterly conference calls, file 8-Ks and intra-quarter press releases or publish regular newsletters with updates on industry trends and the performance of their portfolio. Traditional closed-end funds generally have lower reporting thresholds which are limited to annual and semi-annual reports and a quarterly schedule of investments.

In a low-rate environment, investors are continually on the hunt for attractive sources of income—and for many, closed-end high yield bond and leveraged loan funds fit the bill. However, adding the right BDC to a portfolio that already has high yield exposure may tip the scales in an investor's favor.

FIFTH STREET'S BDCS MAY HELP ROUND OUT TRADITIONAL CLOSED-END HIGH YIELD EXPOSURE

Fifth Street BDCs:	High Yield Bond & Leveraged Loan Funds:
Invest in private small to mid-sized companies	Invest in larger, often public companies
Required to offer managerial assistance	Adopt a passive approach
Access to origination platform, creating potential for incremental fee income and loan discounts	Acquire assets as a passive participant on secondary markets, reducing potential for fee income and loan discounts
Floating rate exposure	High yield bonds may be adversely impacted by higher interest rates
Higher regulatory leverage with greater diversity in capital structure and two investment grade credit ratings for FSC	Lower regulatory leverage, but often with less capital structure diversification compared to larger BDCs
More frequent, in-depth disclosure including regular newsletters	Lower reporting thresholds

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