The Case for Perpetual BDCs in 2024

THE GROWTH AND POPULARITY OF THE PERPETUAL BDC STRUCTURE, AS WELL AS IMPROVED MARKET CONDITIONS, SHOULD DRIVE INVESTOR DEMAND IN 2024.

A Growing Private Credit Alternative

Just three years old, the perpetual business development company (BDC) structure, which unlike a traditional closed end fund accepts monthly subscriptions and offers quarterly liquidity, has become increasingly popular. Perpetual, or evergreen, BDCs have expanded access to the private credit asset class by allowing investors to step into fully ramped and diversified portfolios monthly with very low minimums, enabling them to earn dividends immediately. The structure also allows for quarterly liquidity at net asset value (NAV) and eliminates what many investors considered a flaw of traditional closed end funds: the J-curve nature of the ramp-up period, which also exposes less diversified closed-end fund portfolios to issuer-specific risk during ramp-up and which drives suboptimal returns in the early and later years of an investment. Given these structural advantages, we expect to see greater demand for perpetual BDCs from both institutional and wealth channel investors in 2024.

Looking Back & Looking Ahead

Whereas 2023 was the year of the "add-on," in which private equity firms made small acquisitions, or tuck-ins, to help their portfolio companies grow amid high interest rates that discouraged 'new' deals, 2024 should see an increase in new deal flow. Interest rates have leveled off and appear headed for a possible decline, and private equity firms are likely to feel pressure to harvest existing portfolios and return capital to limited partners. While add-ons accounted for roughly 70% of private credit deal flow in 2023[1], perpetual BDCs without seasoned portfolios were able to participate in only 30% of market volume due to SEC rules governing 1940-Act funds. This lack of new deal flow pushed many perpetual BDCs into more competitive segments of the large corporate market where unadjusted debt and EBTIDA leverage can be extremely high and financial covenants and structural protections are few and far between.

Looking into 2024, market forces should relieve some of this pressure for perpetual BDC managers with less seasoned portfolios, although some portfolios may be stuffed with transactions originated in the more competitive large corporate market segment requiring time for the full story to play out.

On the technical front, new issue pricing as seen in spreads and original-issue discounts (OIDs) tightened over the course of 2023 as inflows accelerated while new deal flow remained muted. This again highlighted the benefits of participating in a fully seasoned portfolio that is diversified by vintage and not overly exposed to any one market environment. In addition, fully seasoned portfolios also were able to participate in add-ons. As new transaction volume likely returns in 2024, we expect a more balanced supply/demand dynamic and pricing may become more lender friendly as a result.

Where the Opportunities Lie

For their equity portfolios, investors generally may hope for annual returns of 8% to 10% over the long run. Those returns, however, are highly dependent on price/earnings valuation multiples that ebb and flow with market sentiment while returns of perpetual BDCs are based on contractual cash flow from the underlying portfolio companies. Today, perpetual BDC/private credit investors have an opportunity to earn equity like returns on portfolios backed primarily by first lien senior secured loans. Typically sitting below a first lien loan in the capital structure are significant levels of equity or junior capital that would absorb losses first if the underlying business valuation declined. Even if the value of an underlying business declined by more than 50%, in a generic "middle" of a middle-market transaction, the first lien loan would still be fully covered. The key point is that private credit returns are not based on a hypothetical earnings growth rate or valuation multiple expansion; they are based on contractual cash flows, which results in low volatility.

1. Source: Barings. As of December 21, 2023.

How to Limit Downside Risk...

Given the compelling returns offered by private credit over more than a decade and a half, investors at times ask what could go wrong. All asset classes have general and specific risks, but perpetual BDCs offer several potential downside protections relative to other asset classes. The following are some of the "lines of defense" available to perpetual BDC investors:

FIRST-LIEN, SENIOR-SECURED STATUS

As first-lien lenders, perpetual BDC investors could see the value of the underlying business decline meaningfully without any impairment to their position at the top of the capital structure.

DIVERSIFICATION

In a highly diversified portfolio, even if something were not to go as planned with a particular investment, the negative result may not materially affect the overall profile of a perpetual BDC's return.

FINANCIAL COVENANTS

Structural protections are critical when considering protection against downside risk. Financial covenants allow lenders to step into a troubled situation early and influence the outcome while collecting amendment fees and/or navigating the best path toward maximizing value for the lender. Many competitive large corporate transactions do not carry covenant packages, but lenders still hold the line and demand covenants in the core 'middle' of the middle market.

INDUSTRY SELECTION

Private credit managers who avoid industries in cyclical sectors of the economy may limit downside risk within the portfolio. Several times over the past 10 years we have seen instances where managers who waded into cyclical sectors such as retail and oil & gas experienced meaningful losses.

HIGH CURRENT INCOME RETURN

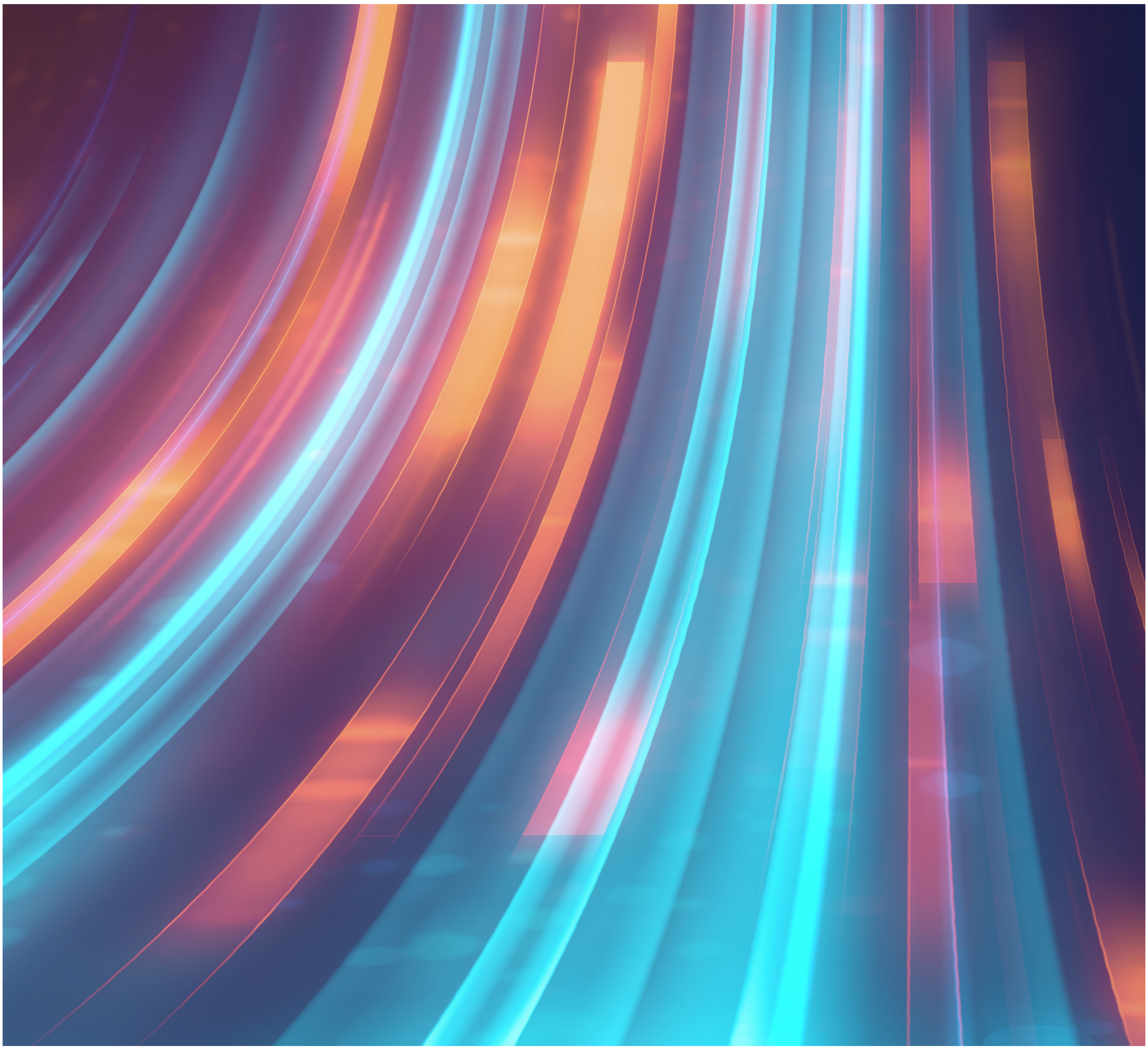
The low double-digit dividend yields currently offered by perpetual BDCs serves as insulation from economic volatility since even modest losses would likely still result in a positive return profile.

FEES

Low and aligned fees are critical to portfolio success as perpetual BDC managers should not earn outperformance fees if the portfolio underperforms. ROE-based hurdle rates well above base rates ensure alignment and support investor returns. Institutional fee structures for best-in-class perpetual BDCs ensure alignment.

The Importance of Manager Selection

While perpetual BDCs are an all-weather asset class, manager selection is crucial. Due to credit performance, the extent of liquid loan exposure, and fees, manager performance of perpetual BDCs has already varied. We expect performance variability to continue and potentially accelerate as the asset class becomes more popular. While few pay attention to financial covenants or conservative underwriting when the environment is broadly favorable and investor interest is high, structural protections and a sharp credit eye really do matter when the tide goes out. Whether or nor the economy escapes recession, private credit portfolios built to weather good times and bad have the potential to outperform.



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Please read the prospectus carefully for a description of the risks associated with investing in perpetual BDCs. These risks include, but are not limited to, the following:

Investments in portfolio companies may be risky, and we could lose all or part of investment. The lack of liquidity in investments may adversely affect business. Price declines and illiquidity in the corporate debt markets may adversely affect the fair value of portfolio investments, reducing net asset value through increased net unrealized depreciation. Failure to make follow-on investments in the portfolio companies could impair the value of portfolio. Portfolio companies may incur debt that ranks equally with, or senior to, investments in such companies and such portfolio companies may not generate sufficient cash flow to service their debt obligations. There may be circumstances where debt investments could be subordinated to claims of other creditors or we could be subject to lender liability claims. Second priority liens on collateral securing loans that made to portfolio companies may be subject to control by senior creditors with first priority liens. If there is a default, the value of the collateral may not be sufficient to repay in full both the first priority creditors . investments in foreign companies may involve significant risks in addition to the risks inherent in U.S. investments.

Any unrealized losses we experience on loan portfolio may be an indication of future realized losses, which could reduce income available for distribution. Defaults by portfolio companies may harm operating results. Changes in interest rates may affect cost of capital, the value of investments and results of operations. Portfolio may be concentrated in a limited number of portfolio companies and industries, which will subject us to a risk of significant loss if any of these companies defaults on its obligations under any of its debt instruments or if there is a downturn in a particular industry. We may not realize gains from equity investments. Investments in asset-backed securities are subject to additional risks.

There is no public market for shares of common stock, and we do not expect there to be a market for shares. There are restrictions on the ability of holders of common stock to transfer shares in excess of the restrictions typically associated with a private placement of securities under Regulation D and other exemptions from registration under the Securities Act, and these additional restrictions could further limit the liquidity of an investment in shares of common stock and the price at which holders may be able to sell the shares. Provisions of the Maryland General Corporation Law and charter and bylaws could deter takeover attempts and have an adverse impact on the price of common stock.

We expect to borrow funds in order to make additional investments, including under the Revolving Credit Facility and other financing arrangements. We expect to use this practice, which is known as "leverage", when the terms and conditions are favorable to long-term investing and well aligned with investment strategy and portfolio composition in an effort to increase returns to stockholders, but this strategy involves significant risks. With certain limited exceptions, we are only allowed to borrow amounts such that asset coverage, as defined in the 1940 Act, is at least 150% immediately after each such borrowing. The amount of leverage that we employ will depend on the Investment Adviser's and Board's assessment of market and other factors at the time of any proposed borrowing.

An investment in a perpetual BDC involves significant risks, and an investor may lose all or part of his or her investment. Additionally, there is the potential that distributions may not be paid, may not grow over time, and may include a return of capital.

IRR calculations have an inherent assumption that investors will be able to reinvest any distributions from the investment at the IRR rate. In practice, it is unlikely that this would occur. Another drawback is that in order to calculate IRR for a portfolio that includes holdings that have not yet been sold (or otherwise liquidated or matured), a valuation of those remaining assets must be estimated. Depending on the nature of the asset, these estimated values may be based on subjective factors and assumptions.

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