

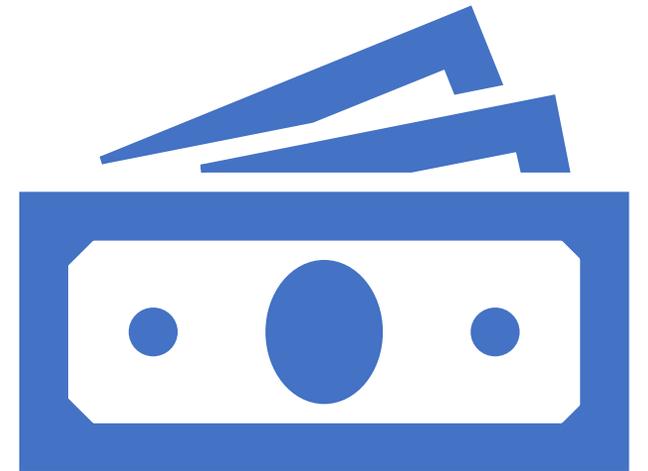
# Business Development Companies

OLLI Investment Forum

David Toms

Graphics by Cindy Kalkwarf

April 13, 2022





# Agenda

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WHAT IS A BDC?

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BDC MARKET OVERVIEW

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HOW TO EVALUATE A BDC

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DEEP DIVE: CAPITAL SOUTHWEST (CSWC)

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CONCLUSIONS

Disclaimer: I am not a professional financial advisor, therefore not responsible for any decisions you might make. Do your own due diligence, and make your own decisions

# What is a BDC?

## Wikipedia Definition:

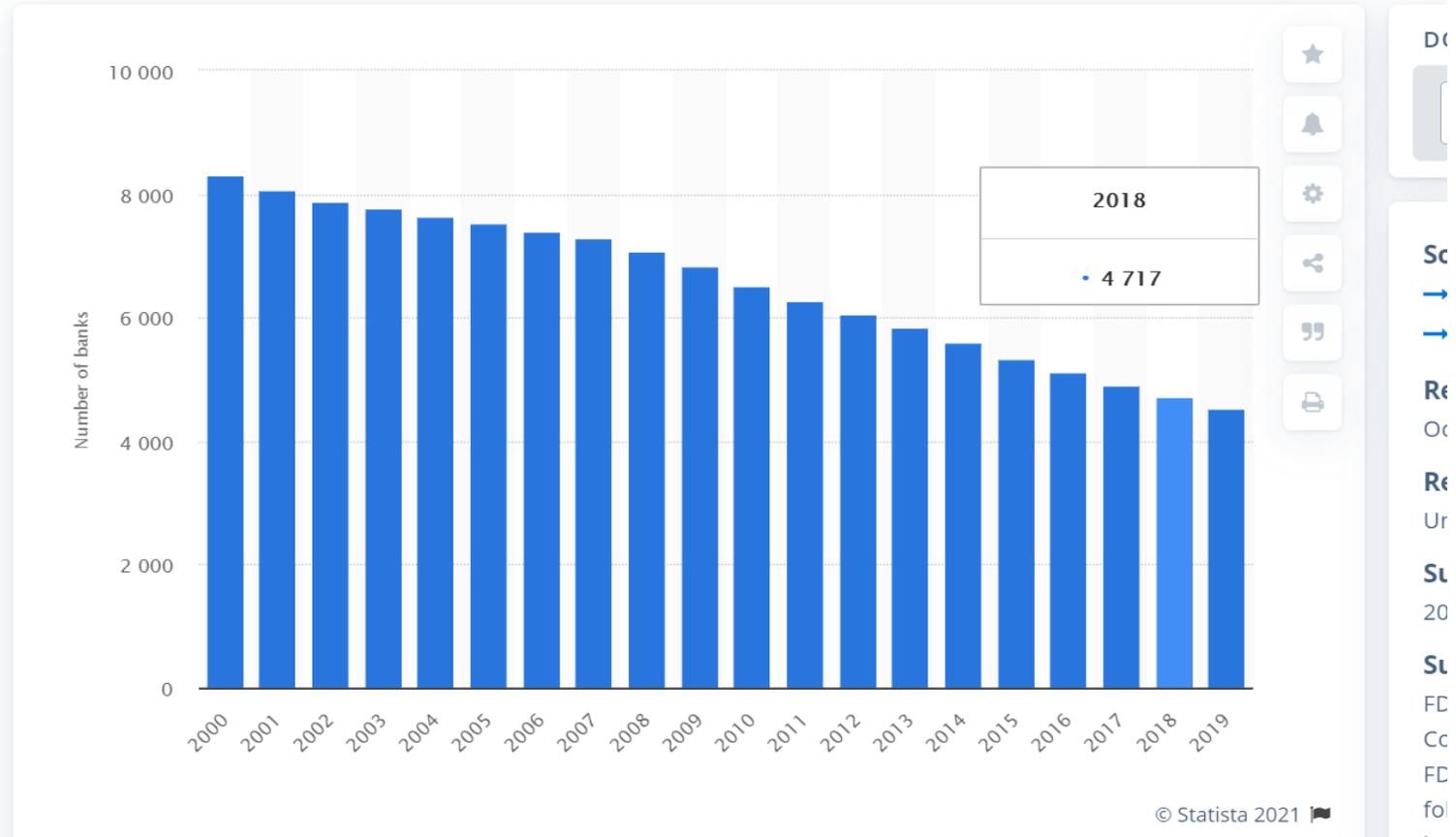
- Established by Congress with the Investment Company Act of 1980; Amended in March 2018
- A company that makes loans to small and mid-size businesses
- Companies use loans to finance expansion, acquisition, LBO, etc
- Regulated by the SEC as Registered Investment Companies (RIC)
- **PAY NO TAXES as long as they distribute 90% of earnings**
- Similar to a REIT, but assets are loans to companies
- **Access to Private Equity or Venture Capital for retail investors**
- Most BDCs are publicly traded – some are not

## Primary reason for investing:

- Long term, alternative investment, high dividends with diversification
- Can result in good returns in a buy and hold portfolio, with a Dividend Reinvestment Program (DRIP)
- Investing is primarily for dividends, not capital gains
- Behave bond-like, except dividends are somewhat variable

BDCs are filling a gap

## Number of FDIC-insured commercial banks in the United States



Source: FDIC

# Types of BDCs

## Market Specialized or Diversified

- Specialized BDCs might invest defensively - Health care or Technology
- Diversified BDCs are just that
- International or US-only?

## Internally managed or Externally managed

- Internally managed BDCs work for shareholders
- Externally managed BDCs work for the managers
  - Can result in conflicts of interest
  - BUT external managers may own a large stake

## Hybrids

- Equity stakes in clients
- Warrants
- Own real estate property and collect rent
- Management services
- Board seats

# Typical BDC Capitalization

## Assets

- First Lien secured loans
  - 75% of portfolio is very good
- Second Lien secured loans
- Senior secured loans
- Mezzanine Loans
- Warrants
- Equity Stakes
- Board seats
- Partnerships and JVs
- Venture Debt
- SBA Facilities
  - Government guarantees

## Liabilities

- Loans from money center banks
  - Revolving credit facilities
- Preferred stocks and dividends
- Common Stocks and dividends
- Notes
- Convertible Notes
- Bonds
- Hedges



BDCs borrow at fixed rates;  
Lend out at floating rates  
Rising interest rates are good for BDCs! Usually.

# BDC Market Landscape

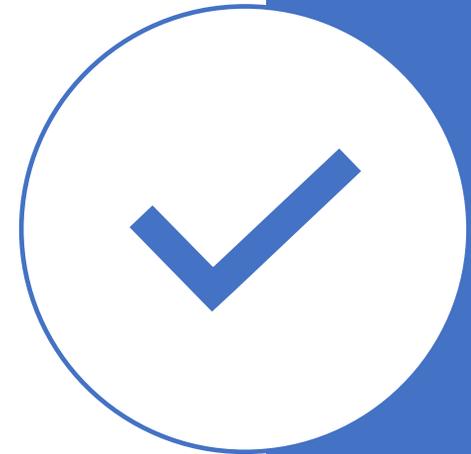
There are approximately 50 BDCs registered with the SEC

Circled BDCs are ones that I own

Largest BDCs by Net Assets			Largest BDCs by Market Cap		
Rank	BDC	Net Assets	Rank	BDC	Market Cap
#1	<a href="#">ARCC</a>	9.27B	#1	<a href="#">ARCC</a>	10.26B
#2	<a href="#">FSK</a>	7.72B	#2	<a href="#">FSK</a>	6.51B
#3	<a href="#">ORCC</a>	5.93B	#3	<a href="#">ORCC</a>	5.90B
#4	<a href="#">PSEC</a>	4.15B	#4	<a href="#">PSEC</a>	3.25B
#5	<a href="#">GBDC</a>	2.61B	#5	<a href="#">MAIN</a>	3.04B
#6	<a href="#">MAIN</a>	1.81B	#6	<a href="#">GBDC</a>	2.59B
#7	<a href="#">GSBD</a>	1.62B	#7	<a href="#">HTGC</a>	2.18B
#8	<a href="#">HTGC</a>	1.34B	#8	<a href="#">GSBD</a>	2.04B
#9	<a href="#">OCSL</a>	1.32B	#9	<a href="#">TSLX</a>	1.77B
#10	<a href="#">NMFC</a>	1.31B	#10	<a href="#">OCSL</a>	1.34B

# How to Evaluate a BDC

- Balance sheet and cash flow adequate?
- What is the quality of the loan portfolio?
  - Quarterly reports to investors
  - Read SEC reports for quality assessments
  - Default ratio < 1% is good
  - During pandemic, 3-4% was typical, but this has diminished
- Is the dividend sustainable?
  - What is the dividend history? Increasing dividend is excellent
  - Monthly or quarterly payout?
- Are Net Asset Value, Net Investment Income increasing?
- What is their leverage ratio? (debt/equity)
- Is the stock selling at a premium to NAV?
- Does the BDC focus on particular business sector(s)?
- Is the BDC externally managed? Or internally?
  - How is management incentivized; AUM or Dividend growth?
- Institutional and Insider holdings?



# How to Evaluate a BDC, cont'd

- S&P Investment grade rating? BBB or better
- What are the qualifications of the managers?
- Analyst opinions?
- Short interest?
- What is the BDC's sensitivity to economic cycles?
- Do they have a Small Business Administration guarantee / license?
- Check SEC 10Q quarterly reports – very insightful
- Read the Blogs on Seeking Alpha
  - Scott Kennedy, BDC Buzz, High Yield Investor (HYI), Brad Thomas
- Simply Safe Dividends provides excellent, in-depth analyses



# Pandemic affects

- SEC stepped in to temporarily relax debt/equity requirements
  - All BDC stock prices dropped approx. 50%, compared to 20% for S&P500
    - Buying opportunities?
  - Dividend affects
    - Some cut dividends (NMFC, Golub Capital...)
    - Some stop supplementals, but kept their base dividend intact (MAIN, CSWC)
    - Some borrowed more to cover, increased leverage
    - All helped their portfolio companies struggle through it
  - All have recovered since Q2, 2020
- 
- Note to self: Be patient; Buy and hold well-managed companies

# My BDC's

25% of my portfolio

Act as bond substitutes

## Ares Capital (ARCC)

- Largest of all BDCs
- Market Cap \$10.4B;  
Yield 7.85%
- Externally managed

## Main Street Capital (MAIN)

- Market Cap \$2.95B
- Yield 6.2%
- Internally managed
- Wall St darling

## Hercules Capital Corp (HTGC)

- Market Cap \$2.2B;
- Yield 10.5%
- Internally managed

# Deep dive: Capital Southwest Corp (CSWC)

## Capital Southwest Corporation (CSWC)

NasdaqGS - NasdaqGS Real Time Price. Currency in USD

[★ In watchlist](#)

[👤 Visitors trend](#) 2W ↓ 10W ↑ 9M ↑

**23.16** -0.14 (-0.60%) **23.14** -0.02 (-0.09%)

At close: 04:00PM EDT

After hours: 04:18PM EDT

[Summary](#) [Company Outlook](#) [Chart](#) [Conversations](#) [Statistics](#) [Historical Data](#) [Profile](#) [Financials](#) [Analysis](#) [Options](#)

Previous Close	23.30	Market Cap	554.119M
Open	23.33	Beta (5Y Monthly)	1.21
Bid	23.00 x 1100	PE Ratio (TTM)	15.19
Ask	23.13 x 900	EPS (TTM)	1.52
Day's Range	23.05 - 23.34	Earnings Date	May 23, 2022 - May 27, 2022
52 Week Range	22.52 - 28.41	Forward Dividend & Yield	1.92 (8.24%)
Volume	91,191	Ex-Dividend Date	Mar 14, 2022
Avg. Volume	132,490	1y Target Est	27.43

Fair Value [?](#) [+](#)

XX.XX

-4% Est. Return

[View details](#)

Near Fair Value

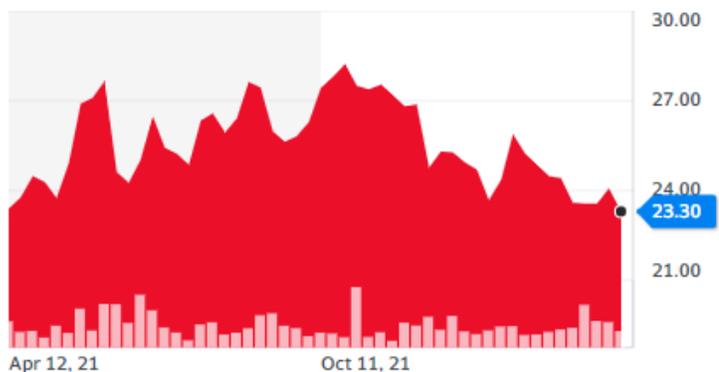


Related Research [?](#) [+](#)

Daily - Vickers Top Insider Picks for 04/08/2022  
The Vickers Top Insider...  
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1D 5D 1M 6M YTD 1Y 5Y Max [👤](#) [Full screen](#)



Trade prices are not sourced from all markets

Chart Events [?](#) [+](#)

Bearish pattern detected

[👤](#) Momentum

[View all chart patterns](#)

Performance Outlook

Short Term 2W - 6W	Mid Term 6W - 9M	Long Term 9M+
↓	↓	↓

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GlobeNewswire • 2 months ago

- Internally Managed
- NAV: \$387M
- ~70 Loans
- 24 Employees
- Based in Dallas TX
- 98% Floating Loans
- 96% First Liens
- Dividends growing steadily



## CSWC Company Overview

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*CSWC is a middle-market lending firm focused on supporting the acquisition and growth of middle-market companies across the capital structure*

- CSWC was formed in 1961, and elected to be regulated as a BDC in 1988
- Publicly-traded on Nasdaq: Common Stock ("CSWC")
- Internally Managed BDC with RIC tax treatment for U.S. federal income tax purposes
- September 2015: completed tax free spin off of CSW Industrials ("Spin Off") (NASDAQ: "CSWI")
- April 2021: received SBIC license from the U.S. Small Business Administration
- 24 employees based in Dallas, Texas
- Total Balance Sheet Assets of \$913 MM as of December 31, 2021
- Manage I-45 Senior Loan Fund ("I-45 SLF") in partnership with Main Street Capital (NYSE: "MAIN")

## ***Investment Strategy***

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### ***CORE: Lower Middle Market (“LMM”): CSWC led or Club Deals***

- Companies with EBITDA between \$3 MM and \$20 MM
- Typical leverage of 2.0x – 4.0x Debt to EBITDA through CSWC debt position
- Commitment size up to \$35 MM with hold sizes generally \$5 MM to \$30 MM
- Both Sponsored and Non-sponsored deals
- Securities include first lien, unitranche, and second lien
- Frequently make equity co-investments alongside CSWC debt

### ***OPPORTUNISTIC: Upper Middle Market (“UMM”): Syndicated or Club, First and Second Lien***

- Companies typically have in excess of \$20 MM in EBITDA
- Typical leverage of 3.0x – 5.5x Debt to EBITDA through CSWC debt position
- Hold sizes generally \$5 MM to \$15 MM
- Securities include first and second lien debt securities
- More liquid assets relative to LMM investments
- Provides flexibility to invest/divest opportunistically based on market conditions and liquidity position

## CSWC invests in:

- later stage ventures
- recapitalization, growth investment
- industrial manufacturing and services
- value-added distribution
- healthcare products and services
- business services
- specialty chemicals
- food and beverage
- tech-enabled services and SaaS models

## CSWC does NOT invest in:

- startups
- publicly traded companies
- real estate developments
- oil and gas exploration businesses
- troubled companies, or turnarounds
- companies in which significant senior management is departing

# Portfolio Statistics

*Continuing to build a well performing credit portfolio*

<i>(In Thousands)</i>	Quarter Ended 3/31/21	Quarter Ended 6/30/21	Quarter Ended 9/30/21	Quarter Ended 12/31/21
<b>Portfolio Statistics</b>				
Fair Value of Debt Investments	\$572,614	\$671,257	\$689,421	\$744,681
Average Debt Investment Hold Size	\$11,228	\$11,377	\$11,490	\$11,820
Fair Value of Debt Investments as a % of Par	97%	97%	97%	97%
% of Investment Portfolio on Non-Accrual (at Fair Value)	—%	1.8%	3.0%	1.6%
Weighted Average Investment Rating <sup>(1)</sup>	2.00	1.96	1.96	1.90
Weighted Average Yield on Debt Investments	10.76%	10.04%	9.66%	9.48%
Total Fair Value of Portfolio Investments	\$688,432	\$798,647	\$818,218	\$876,765
Weighted Average Yield on all Portfolio Investments	10.22%	10.12%	9.60%	9.35%
Investment Mix (Debt vs. Equity) <sup>(2)(3)</sup>	92% / 8%	91% / 9%	91% / 9%	91% / 9%

*(1) CSWC utilizes an internal 1 - 4 investment rating system in which 1 represents material outperformance and 4 represents material underperformance. All new investments are initially set to 2. Weighted average investment rating calculated at cost*

*(2) Excludes CSWC equity investment in I-45 Senior Loan Fund*

*(3) At Fair Value*

## Credit Portfolio Investment Rating Migration

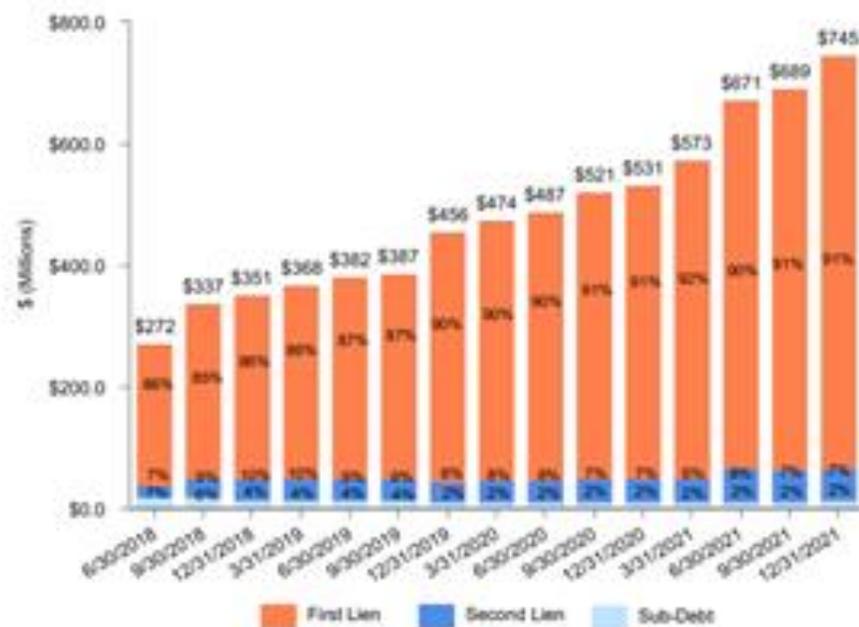
Four loans upgraded and no loans downgraded during the quarter

Investment Rating	9/30/2021			Investment Rating Upgrades			Investment Rating Downgrades			12/31/2021		
	# of Loans	Fair Value (\$MM)	% of Portfolio (FV)	# of Loans	Fair Value (\$MM)	% of Portfolio (FV)	# of Loans	Fair Value (\$MM)	% of Portfolio (FV)	# of Loans	Fair Value (\$MM)	% of Portfolio (FV)
1	8	\$112.5	15.8%	2	\$29.5	4.0%	0	\$0.0	—%	8	\$129.5	17.4%
2	53	\$515.8	73.7%	2	\$24.1	3.2%	0	\$0.0	—%	60	\$580.6	78.0%
3	6	\$58.9	9.7%	0	\$0.0	—%	0	\$0.0	—%	5	\$34.4	4.6%
4	1	\$2.3	0.8%	0	\$0.0	—%	0	\$0.0	—%	1	\$0.2	0.0%
<b>Wtd. Avg. Investment Rating (at Cost)</b>	<b>1.96</b>									<b>1.90</b>		

## Credit Portfolio Heavily Weighted Towards First Lien Investments

91% of Credit Portfolio as of 12/31/2021 in first lien senior secured loans

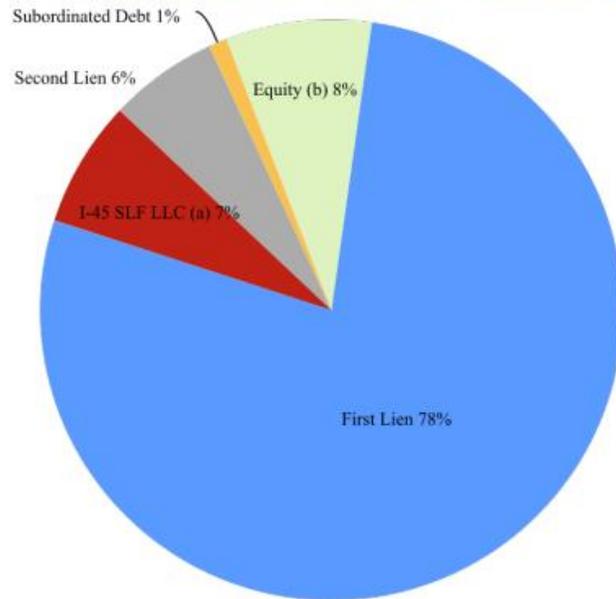
Credit Portfolio Heavily Weighted to First Lien



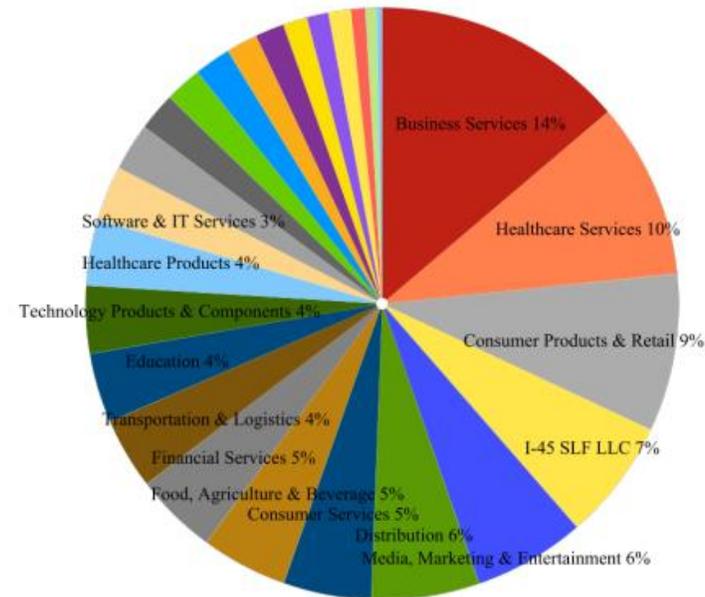
## CSWC Portfolio Mix as of 12/31/2021 at Fair Value

*Current Investment Portfolio of \$877 MM continues to be diverse across industries*

Current Investment Portfolio (By Type)



Current Investment Portfolio (By Industry)



(a) I-45 SLF consists of 95% first lien senior secured debt  
 (b) Equity represents equity co-investments across 39 portfolio companies

## Q3 2022 Originations

**\$268.3 MM in total new committed investments to fourteen new portfolio companies and twelve existing portfolio companies**

- \$213.5 MM funded at close

Portfolio Originations		Q3 2022				
Name	Industry	Type	Total Debt Funded at Close (\$000s)	Total Equity Funded at Close (\$000s)	Unfunded Commitments at Close (\$000s)	Debt Yield to Maturity
Winter Services Operations, LLC	Business services	First Lien	\$20,000	\$—	\$8,889	8.50%
National Credit Care, LLC	Consumer services	First Lien	\$22,500	\$—	\$—	8.88%
Catbird NYC, LLC	Consumer products & retail	First Lien / Equity	\$16,000	\$1,500	\$4,125	9.15%
KMS, Inc.	Distribution	First Lien	\$16,000	\$—	\$4,571	8.69%
South Coast Terminals, LLC	Specialty chemicals	First Lien	\$18,065	\$—	\$1,935	7.96%
ArborWorks, LLC	Environmental Services	First Lien / Equity	\$13,540	\$100	\$2,460	8.88%
Mercury Acquisition 2021, LLC (dba Tele-Town Hall)	Telecommunications	First Lien / Second Lien	\$15,800	\$—	\$—	10.65%
The Producto Group, LLC	Industrial products	First Lien / Equity	\$13,770	\$1,500	\$—	10.90%
Lash OpCo, LLC	Consumer products & retail	First Lien	\$6,500	\$—	\$7,481	8.88%
Infolinks Media Buyco, LLC	Media, marketing & entertainment	First Lien / Equity	\$7,750	\$588	\$2,662	7.80%

## Operating Leverage Trend

Continue to realize operating efficiencies of internally managed structure



Note: Operating Leverage calculated as last twelve months operating expenses (excluding interest expense) divided by average annual assets  
 (1) Operating expenses exclude interest expense

# Income Statement

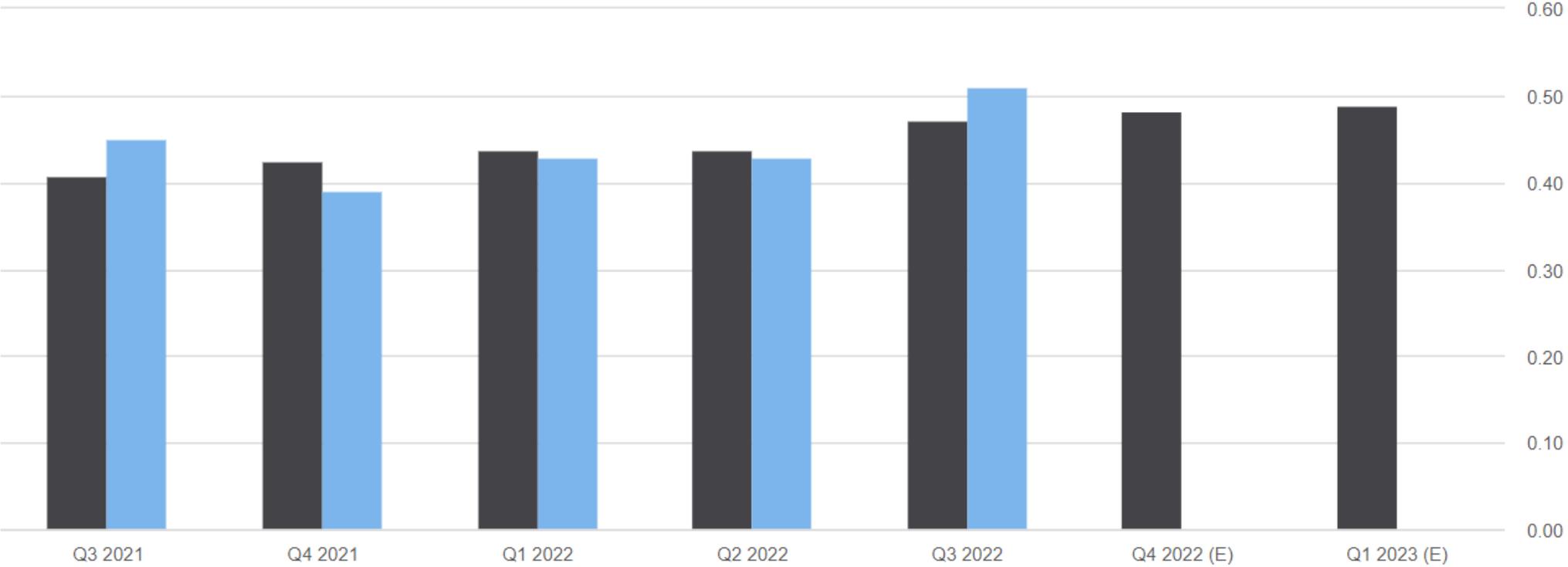
<i>(In Thousands, except per share amounts)</i>	Quarter Ended 3/31/21	Quarter Ended 6/30/21	Quarter Ended 9/30/21	Quarter Ended 12/31/21
<b>Investment Income</b>				
Interest Income	\$12,282	\$14,626	\$16,100	\$16,921
PIK Interest Income	2,796	975	879	814
Dividend Income	1,661	2,657	2,070	1,714
Fees and Other Income	434	321	1,247	2,862
<b>Total Investment Income</b>	<b>\$17,173</b>	<b>\$18,579</b>	<b>\$20,296</b>	<b>\$22,311</b>
<b>Expenses</b>				
Cash Compensation	\$1,631	\$1,432	\$2,298	\$3,353
Share Based Compensation	708	1,076	923	849
General & Administrative	1,278	1,677	1,630	1,617
<b>Total Expenses (excluding Interest)</b>	<b>\$3,617</b>	<b>\$4,185</b>	<b>\$4,851</b>	<b>\$5,819</b>
Interest Expense	\$4,688	\$4,955	\$5,405	\$4,655
<b>Pre-Tax Net Investment Income</b>	<b>\$8,868</b>	<b>\$9,439</b>	<b>\$10,040</b>	<b>\$11,837</b>
<b>Gains / Losses and Taxes</b>				
Net Realized and Unrealized Gains on Investments	\$2,660	\$6,099	\$2,805	\$661
Realized Losses on Extinguishment of Debt	(459)	—	(17,087)	—
Income Tax (Expense) / Benefit	(852)	(396)	(314)	62
<b>Net increase (decrease) in Net Assets Resulting from Operations</b>	<b>\$10,217</b>	<b>\$15,142</b>	<b>\$(4,556)</b>	<b>\$12,560</b>
Weighted Average Diluted Shares Outstanding	20,376	21,202	22,534	23,433
<b>Pre-Tax NII Per Diluted Weighted Average Share</b>	<b>\$0.44</b>	<b>\$0.45</b>	<b>\$0.45</b>	<b>\$0.51</b>

# Earnings Per Share

Period:

Type:

● NII Estimate ● NII Actual



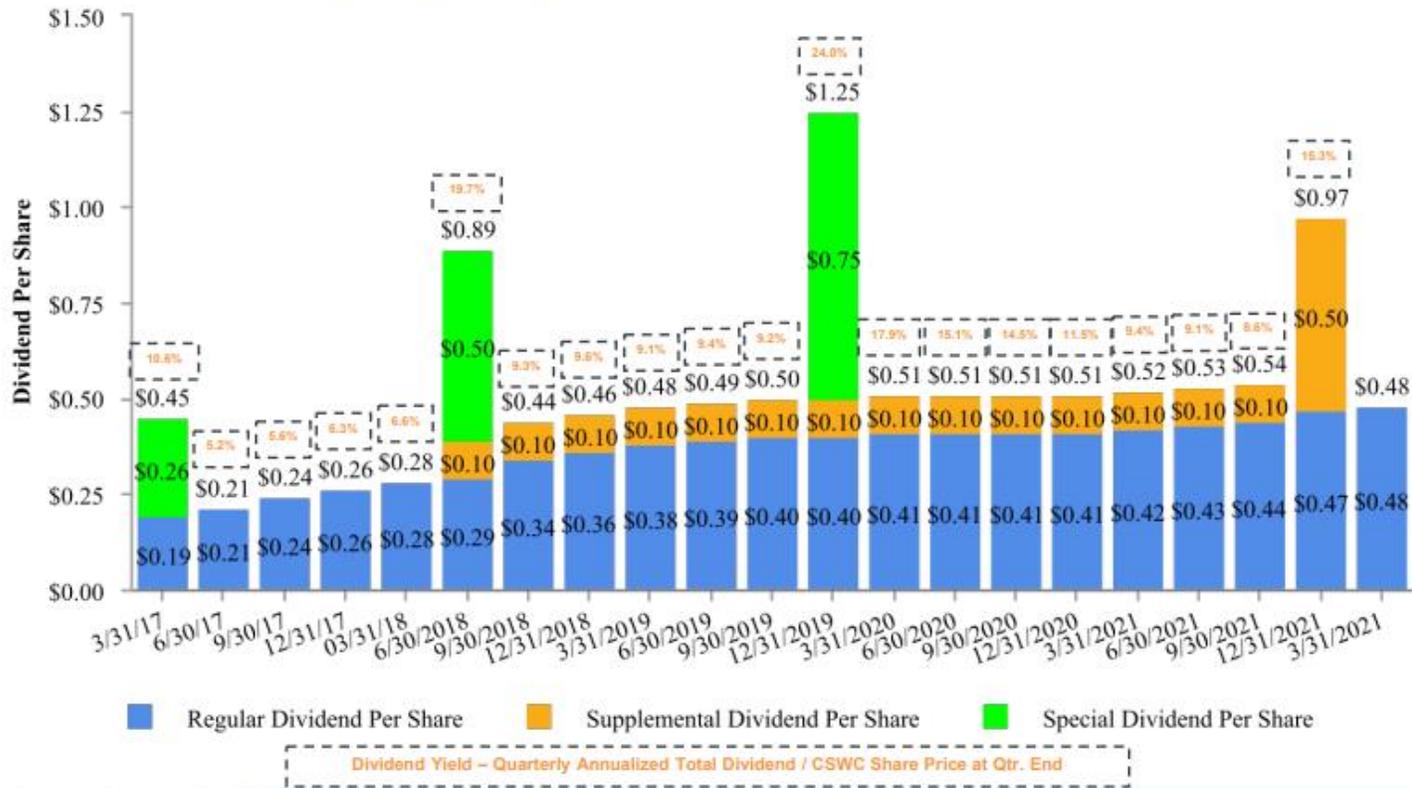
[More on Earnings »](#)

## Balance Sheet

<i>(In Thousands, except per share amounts)</i>	Quarter Ended 3/31/21	Quarter Ended 6/30/21	Quarter Ended 9/30/21	Quarter Ended 12/31/21
<b>Assets</b>				
Portfolio Investments	\$688,432	\$798,647	\$818,218	\$876,765
Cash & Cash Equivalents	31,613	16,543	26,840	18,668
Other Assets	15,539	20,858	21,764	17,122
<b>Total Assets</b>	<b>\$735,584</b>	<b>\$836,048</b>	<b>\$866,822</b>	<b>\$912,555</b>
<b>Liabilities</b>				
SBA Debentures	\$—	\$—	\$16,709	\$27,965
October 2024 Notes	122,879	123,041	—	—
January 2026 Notes	138,425	138,504	138,545	138,630
October 2026 Notes	—	—	97,264	146,357
Credit Facility	120,000	190,000	215,000	190,000
Other Liabilities	18,029	16,408	17,359	22,266
<b>Total Liabilities</b>	<b>\$399,333</b>	<b>\$467,953</b>	<b>\$484,877</b>	<b>\$525,218</b>
<b>Shareholders Equity</b>				
<b>Net Asset Value</b>	<b>\$336,251</b>	<b>\$368,095</b>	<b>\$381,945</b>	<b>\$387,337</b>
<b>Net Asset Value per Share</b>	<b>\$16.01</b>	<b>\$16.58</b>	<b>\$16.36</b>	<b>\$16.19</b>
<b>Regulatory Debt to Equity</b>	<b>1.13x</b>	<b>1.23x</b>	<b>1.18x</b>	<b>1.23x</b>

# Track Record of Consistent Dividends Continues

- In the last twelve months ended 12/31/2021, CSWC generated \$1.84 per share in Pre-Tax NII and paid out \$1.76 per share in Regular Dividends
- Cumulative Pre-Tax NII Regular Dividend Coverage of 107% since the 2015 Spin-Off
- Total Special and Supplemental Dividends of \$3.41 per share since the 2015 Spin-Off
- Undistributed Taxable Income ("UTI") of \$0.32 per share as of December 31, 2021



# Ownership



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DJIA: 34,818.27 +139.92 (0.40%) | NASDAQ: 14,261.50 +40.981 (0.29%) | S&P 500: 4,545.86 +15.45 (0.34%) — Markets closed

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## Ownership & Insiders: CSWC

CAPITAL SOUTHWEST CORP  
**24.07** ↑ **0.34 (1.4328 %)** AS OF 4:00:01PM ET 04/01/2022

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### Ownership Summary

	<b>Institutional Stock Ownership</b>	22.8%
	<b>Institutional Mutual Fund Ownership</b>	1.7%
	<b>Mutual Fund Ownership</b>	0.3%
	<b>Insider Ownership</b>	16.0%
	<b>Other</b>	59.1%

### Institutional Ownership Details

		Current Quarter	Previous Quarter
	<b>Institutional Share Purchases</b>	429.5K	411.3K
	<b>Institutional Shares Sold</b>	241.0K	649.8K
	<b>Net Institutional Shares Purchased</b>	188.6K	--238.50K
	<b>Change in Ownership</b>	3.32%	-4.03%

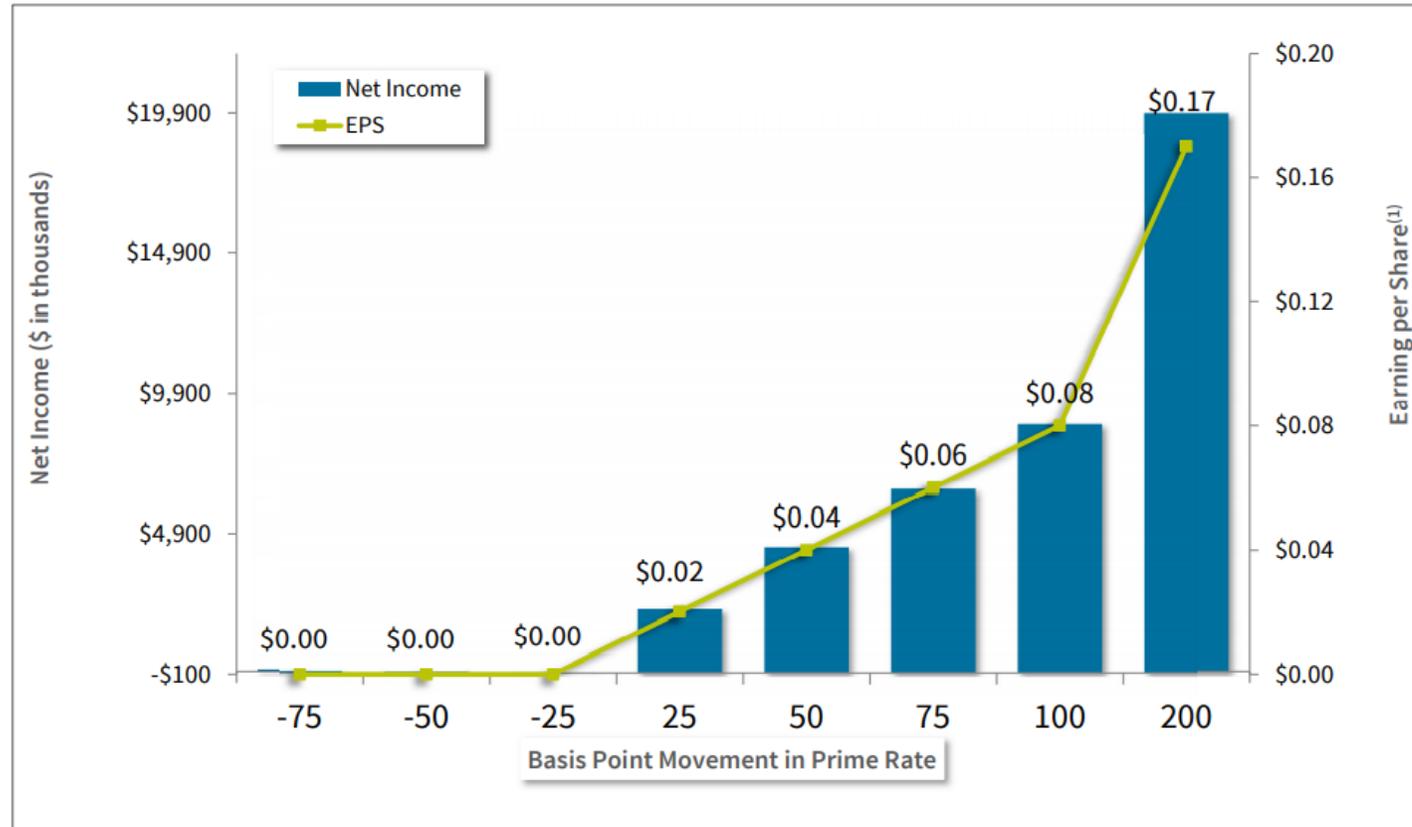
Source: Fidelity

# Other criteria

- Analyst opinions
  - Morningstar: Fairly valued
  - Seeking Alpha (BDC Buzz): Strong Buy
  - Yahoo: Buy
  - Fidelity: Neutral
- RSI = 39, decreasing (at 30 – likely buying opportunity)
- Beta = 1.2 (somewhat more volatile than S&P500 over 5 years)
- Short interest: 1%
- Market Cap / NAV: 160%
- YTD performance: down 10% vs down 8.6% for S&P500
- From Q3 CEO Transcript: “Dividends will continue to increase”
- Conclusion: Good company; conservatively managed; small but growing; price is high right now; will wait and watch

# Interest Rate Sensitivity

## INTEREST RATES & ASSET SENSITIVITY



(1) EPS calculated on basic weighted shares outstanding of 113.9 million and a static debt investment portfolio as of December 31, 2020. Estimates are also subject to change due to impact from potential participation in the Company's equity ATM program and future equity offerings.

# Conclusion

## Why BDCs ?

- Borrow at fixed rates; lend out at floating rates
  - Usually a tailwind
  - Stock price is more affected by the general market
- Required to distribute 90% of earnings directly to shareholders
- Pay no (or very little) Federal taxes

## Who invests in BDC's?

- Long term investors looking for alternative investment, or dividends, willing to accept a higher level of volatility and risk in exchange for higher yield
- Must be combined with DRIP to get full benefit

## How to assess BDC investment opportunity?

- Portfolio quality and dividend sustainability are most important
- Many sources of information available

## GLTA!

Warren Buffett: "The stock market is a mechanism for transferring wealth from the impatient to the patient."

# Sources: [www.capitalsouthwest.com](http://www.capitalsouthwest.com)

## Seeking Alpha Blogs

- BDC Buzz
- Scott Kennedy
- Colorado Wealth Management
- High Yield Investor

## Fidelity, Schwab, Vanguard

## Morningstar

## Simply Safe Dividends

## BDCInvestor.com

## SEC 10Q reports