BDC Fees and Structures Evolving

Multiple drivers spurring change

HAMLIN LOVELL TALKS TO SCHULTE ROTH & ZABEL'S JOHN J. MAHON

A proliferation of different fee levels and structures is evident throughout the alternative investment industry, and Business Development Companies (BDCs) are no exception. For instance, management and incentive fees within the BDC space vary widely between issuers, with management fees ranging from as low as 1% to as high as 2% of gross assets. Throughout the industry, common drivers for revisiting existing fee structures include changing market norms and pressure from investors. BDCs can face additional demands to alter fees and terms in view of their public nature. Being publicly listed opens the door to pressure from both analysts and activist investors, and BDC regulation, namely section 15 under the Investment Company Act of 1940, or the "1940 Act", requires boards of directors of BDCs to review and reapprove fee agreements annually.

Netting between sources of incentive fees

BDC fee structures have, historically, been based on the same principles as for other funds - and were superficially similar. Headline fees were, traditionally, 2% management fees and 20% incentive fees, applying to both net investment income and realised capital gains, calculated net of realised losses and unrealised depreciation. Even today, for each of these return streams, the incentive fee has special criteria, intended to ensure that incentive fees applied only to net and new profits. "For the net investment income incentive fee, there is typically a hurdle and a catch-up feature, to mirror private fund waterfalls. Typically, a 6-8% hurdle applies, after which the catch-up provision lets managers receive 100% of net investment income above the hurdle until they got caught up to 20% of total net investment income," explains Schulte Roth & Zabel investment management partner John J. Mahon, who is based in the firm's Washington D.C. office and regularly assists clients in connection with the establishment and operation of BDCs and both open-ended and closed-ended registered funds. "For the realised capital gains incentive fee, regulatory provisions applicable to BDCs govern the calculation. As a result, the capital gains incentive fee requires BDCs to take into account both capital losses and unrealized depreciation, but excludes unrealized appreciation in a BDC's portfolio," he goes on.

But BDC fees have shown somewhat unique quirks, partly as a consequence of regulatory complexity. Viewed independently, each of the two sets of incentive fee calculations seem similar enough to those applying on many other funds. "But the nuance is that the incentive fee structure for a BDC is bifurcated, with net investment income calculated separately from realised capital gains," explains Mahon. This absence of netting created the potential for BDCs to continue receiving incentive fees from net investment income, even if it was outweighed by realised capital losses and/or unrealised depreciation (and even after some BDCs cut their dividends). The spike in corporate defaults, seen in the wake of the global financial crisis, shone the spotlight on this anomaly, as some BDCs did, indeed, suffer substantial write-downs. Conversely, the issue has always remained largely theoretical for the best performing BDCs.

New fee structures

Mahon, who advises BDCs, has seen fees changing in two main ways. "The typical base management fee for a new BDC launch has come down from 2% to between 1.75% and 1.5%, with some even lower," he observes. And an element of netting has been introduced between the two sources of incentive fees. BDCs do not at present have the type of perpetual high water mark seen on many hedge funds "but the objective is to get to something similar that acknowledges large losses and depreciation," says Mahon. Many BDCs' incentive fees on net investment income are now subject to a quarterly test of realised capital losses and unrealized depreciation, based on a three year, twelve quarter, lookback period. "This is being described as a clawback. Although it is not actually a clawback in the same sense as one sees in the private fund context, it is designed to operate in much the same way," explains Mahon. Another incentive fee model involves a promised return or yield, which can be conceptually similar to a hurdle rate. "A few BDCs have adopted a 12-month lookback that focuses on a particular rate of return to investors, taking account of dividends and changes in net asset value, including realized losses and unrealised depreciation. If the net asset value of the fund decreases substantially, the manager may be forced to defer incentive fees it would have otherwise been paid," points out Mahon.

Non-fee expenses are also being scrutinized throughout the investment industry, with regulators keeping a close eye on the levels, and allocations, of costs. "It is much more common for some of the smaller BDCs, under perhaps $500 million of assets, to see advisor caps on reimbursements of expenses. This in effect caps the total expense ratio of the BDC so that the adviser effectively bears some of the operating expenses," Mahon has noticed.

Investor pressure and annual reviews

"These new fee structures were first seen in BDCs conducting IPOs, and later adopted by other BDCs in response to analyst and investor pressure," recalls Mahon. Market and investor pressures are the most common reason for existing publicly-traded BDCs to change their fee structures, according to Mahon. Every year EY's Global Hedge Fund and Investor Survey shows average management fees coming down. With a growing number of hedge funds now pursuing direct lending strategies, it is natural that BDCs want their fees to remain competitive with those of other investment vehicles.

Additionally, "the annual review process sharpens BDCs' focus on fees," says Mahon. Other exchange-listed investment vehicles, such as REITs and MLPs, may share some similarities with BDCs, in being required to distribute most of their income to retain tax benefits. But a crucial difference is that "REITs and MLPs do not need to get their management agreements re-approved annually, so their terms are, usually, extremely manager-friendly and more so than in the BDC space. Terms have to be more neutral to meet the expectations of independent board members and survive judicial scrutiny if challenged in court, among others," Mahon observes. The annual board review and re-approval process under Section 15 of the 1940 Act, as well as the threat of litigation under Section 36(b) of the 1940 Act, can sometimes force changes in fee structures, particularly where BDCs are charging different fees for different vehicles (which Schulte Roth & Zabel lawyers have written about for *The Hedge Fund Journal*). However, the annual Section 15 re-approval process for a BDC's advisory agreement is already an onerous one. Mahon sees much time devoted to "preparing detailed materials, reports and analyses to provide to directors, to inform the annual advisory agreement re-approval process".

Limited role for activists

Activist campaigns have prompted fee revisions at some lower performing BDCs, though there are limits to the extent of activist involvement in several respects. Mahon points out that "for any kind of 1940 Act fund, certain provisions impact how much equity a single private fund can acquire. Most hedge funds are private funds exempt from registration, and typically cannot acquire more than 3% of a BDC's outstanding shares, for example". Sometimes, more than one activist has been invested in the same BDC, but the recovery in BDC valuations may have reduced activists' appetite for the space. "18 months ago, there was a perfect storm, with M&A activity, investor discontent, and certain lower-performing BDCs trading at significant discounts to NAV appealing to activists - but now discounts have narrowed the space may be of less interest," reflects Mahon.

Another factor that can often cramp activists' style is the corporate governance framework around BDCs. Activists have proposed alternative nominees, challenged potential M&A transactions, and sought to replace advisors in the BDC space, but it can sometimes be difficult for them to prevail. "Any attempt to transfer or assign a BDC's advisory agreement can trigger termination of the agreement and a new shareholder vote to replace it. Also, while under shareholder proposal rules any shareholder activist can submit a proxy for BDCs to terminate existing advisor agreements, it is rare that such proposals succeed given the high vote threshold under the 1940 Act, which requires the affirmative vote of the lesser of 67% of the shares voted, if a majority of the shares are present, or a majority of the outstanding shares," Mahon observes.

Continuity in fee structures

Irrespective of activist pressure, some BDCs have not altered their fees, for the same reason that the most sought-after hedge funds continue to command above average fees. "Those performing well do not face the same pressure to change fees. Investors like the returns, and if there are no credit issues, and no write downs, then the market will typically be satisfied with their structure," Mahon explains. Indeed, some aspects of BDC fee structures are not changing. In common with some closed end funds and REITs, BDCs continue to charge fees on their gross assets, "but most now have a carve-out provision that prohibits charging on cash or cash equivalents," Mahon caveats. This contrasts with private funds and hedge funds that nearly always charge fees based on net assets. However, in practical terms, BDCs' practice of levying fees on gross assets generally does not result in much higher overall fee levels, because BDC leverage is restricted. Under the 1940 Act it is capped at approximately a 1:1 equity: debt ratio, but in practice leverage is generally lower as BDCs tend to operate within a safe margin below that limit. Most BDCs also have issued public debt, which is rated by credit ratings agencies and closely watched by investors, acting as further constraints on leverage. Given BDCs' moderate leverage, fees of 1.5% or 1.75% of gross assets generally do not work out at being much more than equivalent to 2% of net assets.

Future fee trends

Mahon expects that "tiered, or lockstep, management fee structures could potentially gain traction as consolidation in the sector creates larger multi-billion dollar platforms". These fee structures could involve one management fee up to, say, $1 billion of assets that may be higher than other BDCs currently charge, and a reduced fee above $1 billion, which drops another notch above $1.5bn. Such a tiered approach may help bridge the gap between the higher relative expenses incurred by a BDC's adviser when its asset base is smaller and the analyst and investor focus on lower fees within the space. For now, Mahon finds "these fees are being discussed a lot more but not implemented yet".

While at least one BDC operates with a 17.5% incentive fee, versus the more traditional 20%, Mahon does not expect a tiered incentive fee approach to take hold within the BDC space. Mahon points out that "a tiered incentive fee structure arguably dilutes alignment between advisers and investors". Instead, he sees more movement on the hurdle rates, which typically range between 6% and 8%, with 7% an often-seen average. Hurdles come in different flavours. BDC hurdles are conceptually different from other funds' fee provisions that are also described as "hurdles". BDC hurdle rates are generally a trigger point for payment of performance fees, in contrast to hurdle rates on hedge funds that only apply performance fees above the hurdle rate. For most BDCs, once the hurdle is surpassed, catch up provisions mean that performance fees, in effect, apply to returns both above and below the hurdle. The manager can receive 100% of the performance above the hurdle, until he is caught up with the performance fee. So, for an 8% hurdle rate and a 20% performance fee, the manager could receive all of the annualised returns between 8% and 9.6%.

Alignment of interests

Changes to fee structures are one part of the ongoing dialogue around alignment of interests between investors and advisers. Another important facet of this discussion is of course manager co-investment, or "eating their own cooking". In the United States, public funds need to disclose personal investments by officers of the BDC. Mahon sees a range of ownership levels but stresses "skin in the game has always been a big point for investment banks marketing BDCs, to show that management team interests are aligned with those of investors. And if BDCs are part of smaller managers, it becomes even more important that they own a piece of the BDC".

Private BDCs

With at least $670 billion of capital now deployed in direct lending, according to AIMA and Deloitte's survey, Financing the Economy 2016, the 52 publicly listed US BDCs – with market capitalisation around $60 billion in late 2015 – are sizeable players but probably not the largest category of non-bank lenders. BDCs' new issuance has been held back partly by the discounted valuations of the sector, because BDCs cannot issue shares below NAV without shareholder approval. The growth of BDCs is also limited because they lend to smaller and medium sized companies. Such firms may struggle to obtain funding from banks or capital markets.

Indeed, the number of companies listed on US exchanges has roughly halved from 8,000 in 1996 to just over 4,000 in 2016, possibly due to costs associated with regulations such as Sarbanes Oxley. BDCs lend to both public and private companies. Some BDCs may decide that they themselves do not need a public listing or not, at least initially. BDCs were first created in 1980 and were only allowed to list on exchanges in 1990 but some investors and advisers do not feel that a public listing is essential on day one. Thus, in some quarters, the industry is coming round full circle to its origins when, in the 1980s, BDCs were private funds.

The data on public BDCs assets undoubtedly understates the size of BDC assets as it does not include assets managed by private BDCs. Mahon has seen some substantial launches of private BDCs. "One manager has reportedly raised over $2 billion for a new private BDC that draws down capital like a traditional private credit fund. These private BDCs are marketed to the same types of investors who buy private funds, but have the ability to ultimately become a publicly-traded BDC at some future point," he notes.

Private BDCs can have manifold advantages. Taxation is a major draw of the structure, which appears to be simpler than many master/feeder setups. Traditionally, with direct lending strategies in the US, offshore investors face potential exposure to US taxes. "For a private BDC, offshore investors can often go directly into one vehicle, which can directly originate loans, reducing two or more entities to one," says Mahon. "Private BDCs also benefit from SEC oversight in the form of public reporting obligations that match those of publicly-traded BDCs," he adds.

Private BDCs fees can be at the lower end of the range, with base management fees under 1% until and unless they become publicly traded. "Altogether the adviser often has a much easier story to tell when marketing a private BDC," sums up Mahon. THFJ

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