Introduction to Business Development Companies

What is a BDC?

Business Development Companies (BDCs) are a special type of closed-end fund created by Congress in 1980 in order to provide small and medium sized companies access to capital. A BDC is regulated under the Investment Company Act of 1940 (the "1940 Act") and must invest at least 70% of its capital in "qualifying" assets, principally loans to U.S. private companies. Additionally, BDCs must distribute at least 90% of net taxable income. The regulated investment company (RIC) status of BDCs also provides offshore investors a tax-efficient way to access U.S. loan origination.

Because of many of the structural features of BDCs, these investment vehicles have become an increasingly attractive way for individual investors to access direct lending opportunities in private credit markets, an asset class historically only accessible by institutions or high-net-worth individuals.

BDCs combine many elements of 1940 Act mutual funds and traditional private vehicles. Below, we summarize key similarities and differences between the three vehicle types:

	Mutual Funds	BDCs	Private Vehicles
1940 Act Registered	✓	✓	
Investor eligibility	No eligibility requirement	Generally, either net worth >$250,000 or gross annual income >$70,000 and net worth of >$70,000[1]	Qualified Purchaser[2]
Private credit allocation	15% max[3]	>70%[4]	Fund-specific / no statutory constraint
Liquidity	Daily[5]	Periodic (typically quarterly)	Illiquid, return of capital during harvest period[6]
Minimum investment	Typically, $1,000	Typically, $2,500	Typically, $5,000,000
Fees	0.59%[7]	Typically, 1.25% management fee & 12.5% incentive fee on 5% investment return hurdle	Typically, 1-1.5% management fee & 10-20% incentive fee on 5-7% investment return hurdle
Leverage[8] (debt-to-equity)	0.3x	2x regulatory cap	Generally, 1x – 2x
Tax reporting	1099-DIV	1099-DIV	K-1

Source: OHA, as of August 2023. **Not Product or Services Related – For Educational Purposes Only.** [1]Selected states and brokers may have additional investor eligibility and suitability requirements. [2]A Qualified Purchaser is defined as (1) any natural person who owns not less than $5,000,000 in investments, (2) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouse), or direct lineal descendants by birth or adoption, spouses of such persons, (3) any trust that was not formed for the specific purpose of acquiring the securities offered, or (4) any person acting for its own account or the accounts of another qualified purchaser who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments. [3]There may be some limitations, as funds must maintain liquid assets sufficient to meet redemption requests. [4]BDCs must invest at least 70% of their assets in qualified assets, which includes investments in private U.S. companies, or investments in public U.S. companies with market cap <$250m. [5]Daily liquidity refers to the ability to redeem shares on a daily basis. Typically, shares of a mutual fund that are eligible to be redeemed daily receive pricing upon market close at 4pm (ET). [6]Harvest period refers to the period of a fund's life where the focus is on helping the underlying companies grow and on exiting the investments. [7]Morningstar, as of December 2022; 0.59% is the asset-weighted average expense ratio for active funds. 8Leverage is a fund's ability to borrow capital to make additional capital available to increase assets, cash flows and returns.

The BDC market has grown meaningfully since the creation of these investment vehicles. As mentioned, these vehicles typically provide access to private credit, particularly direct lending. Historically, traditional banks were the lender of choice for any size company to address financing needs, however, three developments over the last few decades have shrunk banks' appetite for leveraged credit exposure. These developments include (1) bank consolidation, (2), regulatory changes, and (3) tighter leveraged lending. Because of these changing dynamics, bank lenders began to primarily service larger companies, creating a void for small and medium sized companies. This created an attractive opportunity for alternative, non-bank lenders, such as BDCs, to step into the gap and provide financing to these companies at attractive interest rates.

More recently, larger companies have begun shifting away from banks and toward private markets for their financing solutions for a few reasons including speed of execution, confidentiality, more tailored structures, no ratings requirements and the benefits of working with small group of lenders.

The landscape for lenders isn't the only thing that has evolved over time. The types of BDCs available to investors have also evolved, creating more ways for investors to consume these vehicles and their underlying private credit exposure.

BDCs come in a few different forms, but the three most common are public BDCs, non-traded BDCs and private BDCs. Below, we explore the three types of BDCs prominent in today's market:

	Public BDC	Non-Traded BDC	Private BDC
Investor suitability	No eligibility requirement	Minimal	Accredited Investors
NAV frequency	No NAV; share price set by market	At least quarterly, but typically monthly	At least quarterly
Liquidity	Daily via exchange	Quarterly repurchases	Varies, typically fund liquidity event or wind-down
Exchange listed	Yes	No	No, unless listing is for liquidity
Offering period	Initial Public Offering (IPO)	Continuously offered	Private placement during commitment period
Term	Perpetual	Perpetual	Typically, 5-7 years

BDCs often involve high costs to invest and high maintenance costs such as periodic management fees and net capital gains. Investors should read a fund's prospectus carefully before investing to understand a BDC's fees and costs.

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BDCs are generally not taxed at the corporate level to the extent they distribute all of their taxable income in the form of dividends. Ordinary income dividends are taxed at individual tax rates and distributions may be subject to state tax. Each investor's tax considerations are different and consulting a tax advisor is recommended. Any of the data provided herein should not be construed as investment, tax, accounting or legal advice. BDCs may charge management fees, incentive fees, as well as other fees associated with servicing loans. These fees may detract from the total return. Account opening and closing fees may apply depending on the amount invested and the timing of the account closure. There may be costs associated with the investments in the account such as periodic management fees, incentive fees, loads, other expenses or brokerage commissions. Fees for optional services may also apply.

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