The Brass Tacks of U.S. Business Development Companies and the S&P BDC Index

The S&P BDC Index benchmarks the rapidly growing Business Development Company (BDC) segment, which consists of uniquely structured private equity firms. Some key highlights of these firms include:

- BDCs are private equity firms that invest in small- to medium-size companies and make managerial assistance available to portfolio companies.
- BDCs elect to be designated as regulated investment companies (RICs). This generally allows them to avoid corporate income tax by passing on most of their taxable income to shareholders. Thus, they typically have higher dividend yields than common stocks.
- Various BDCs are publicly listed on U.S. securities exchanges, which combines the liquidity of public listings with underlying exposure to relatively illiquid private debt and equity investments.
- The current value of the listed U.S. BDC market is over USD 30 billion, and the market capitalization of the group grew at a compound annualized rate of 39% from the end of 2009 through 2013.¹
- The number of listed BDCs has increased by 78% in the last five years.²
- The S&P BDC Index serves as an investable benchmark that tracks the listed U.S. BDC segment. The index consists of leading, liquid BDCs that trade on major U.S. exchanges.

Introduction to BDCs

The BDC structure was authorized in 1980 when the U.S. Congress amended the Investment Company Act of 1940 with the Small Business Incentive Act. BDCs are closed-end investment companies that facilitate the flow of capital to small- and medium-size private enterprises. They elect to be treated as RICs for tax purposes. As such, BDCs generally do not pay corporate income tax, but they must pass through at least 90% of eligible income to shareholders. This category has grown significantly in recent years, with the number of listed BDCs increasing from 27 at the end of 2008 to 48 as of year-end 2013.³

¹ Based on Compustat data as of Jan. 15, 2014.
² Ibid.
³ Ibid.
Distinguishing Characteristics

- **Tax Treatment:** BDCs are structured as pass-through investment companies, so they generally do not pay corporate income taxes. Taxes are only paid at the personal level when distributions are received by shareholders, thus avoiding the double taxation faced by most other corporate structures.

- **Relatively High Dividend Yield:** Since BDCs generally pass through most of their taxable income, yields are relatively higher than many other investment options.

- **Diversification Requirements:** As investment companies, BDCs fall under the purview of the Investment Company Act of 1940. Therefore, 50% of the investments in a BDC’s portfolio must represent less than 5% of the total portfolio. In addition, no single investment may exceed 25% of the overall portfolio.

- **Limited Leverage:** The total-debt-to-total-equity ratio cannot surpass 1 to 1.

- **Exposure to Small, Privately Held Firms:** At least 70% of a BDC’s portfolio must be invested in qualifying assets, which generally are securities of eligible portfolio companies (small, privately held firms that meet limits on assets and capital).

- **BDC Management:** Some BDCs are managed by third-party companies, while others are managed internally. Management compensation may include several elements: asset-based management fees, incentive compensation after meeting performance hurdles, a defined percentage of net capital gains, administrative fees (for external managers), and employee benefits packages (for internal managers).

- **Sharing of Management Expertise:** To count holdings toward the 70% qualifying-asset criteria, BDCs must either own controlling stakes in portfolio companies or make significant management assistance available to portfolio companies.

Investing Advantages

- The pass-through structure of BDCs results in relatively high dividend yields and the avoidance of double taxation.

- Publicly-listed BDCs offer exposure to private equity and venture capital opportunities with intraday liquidity and no minimum investment.

- BDCs may offer diversification benefits due to their less-than-perfect correlation to other equities.

Potential Risks

- **Credit Risk:** Some BDC portfolio holdings may be rated below investment grade or not have a credit rating.

- **Market Risk:** Valuations of portfolio holdings could be volatile because BDCs generally invest in small, sometimes financially troubled businesses.

- **Interest Rate Risk:** BDCs finance some of their portfolio investments with bank or capital market borrowing, so higher interest rates may translate into higher costs over time.

- **Dependence on Key Personnel:** Performance of portfolio companies, and BDCs themselves, might be reliant upon the presence of key executives and managers.

- **Asset/Liability Mismatch:** BDCs may engage in relatively short-term revolving credit facilities and may lend to portfolio companies on a longer-term basis. Bank facilities generally contain covenants relating to debt loads and debt-to-equity ratios, so market distress could trigger difficulties when seeking short-term funding.

- **Dividend Payout Risk:** Distressed market conditions could lead to reductions in dividend payouts.
- **Relatively High Expenses**: BDC management fees might be high, relative to other investment management fees.
- **Regulatory Risk**: If the BDC regulatory structure, pass-through tax status, or related governance rules were altered, the change could have adverse consequences on the BDC industry.

### What is the Size of the BDC Market?

By December 2013, the number of listed BDCs in the Compustat database had grown to 48, with a total market capitalization of USD 30,657 million. The compound annual growth rate of the BDC market value was 39% from December 2009 to December 2013.

#### Exhibit 1: Size of BDC Market

![Size of BDC Market Graph]


### Return and Volatility Profile of BDCs

BDCs have not historically moved in lock-step with stocks, bonds, or other high-yielding equity categories such as real estate investment trusts (REITs) and master limited partnerships (MLPs). Exhibit 3 shows that, as represented by the S&P BDC Index, their historical (over the five years ending 12/31/2013) correlation to other equity categories ranges from 0.80 versus the S&P 500 to 0.64 versus the S&P MLP Index. Correlations to U.S. fixed income, as represented by the Barclays U.S. Aggregate Index over the same time period, was -0.23.
Exhibit 2: Daily Total Returns

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P BDC (%)</th>
<th>S&amp;P 500 (%)</th>
<th>S&amp;P MLP (%)</th>
<th>S&amp;P U.S. REIT (%)</th>
<th>BarCap Agg. (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-Year</td>
<td>27.60</td>
<td>18.09</td>
<td>30.50</td>
<td>11.85</td>
<td>4.46</td>
</tr>
<tr>
<td>Ann. Std. Dev.</td>
<td>35.54</td>
<td>19.45</td>
<td>17.63</td>
<td>37.24</td>
<td>3.62</td>
</tr>
<tr>
<td>CAGR/Ann. Std. Dev.</td>
<td>77.67</td>
<td>93.03</td>
<td>173.01</td>
<td>31.81</td>
<td>123.11</td>
</tr>
<tr>
<td>3-Year</td>
<td>12.05</td>
<td>16.14</td>
<td>15.77</td>
<td>6.14</td>
<td>3.22</td>
</tr>
<tr>
<td>CAGR/Ann. Std. Dev.</td>
<td>56.48</td>
<td>97.32</td>
<td>104.54</td>
<td>28.00</td>
<td>98.66</td>
</tr>
<tr>
<td>1-Year</td>
<td>17.07</td>
<td>32.39</td>
<td>29.75</td>
<td>9.92</td>
<td>-2.02</td>
</tr>
<tr>
<td>Ann. Std. Dev.</td>
<td>12.98</td>
<td>11.07</td>
<td>13.00</td>
<td>15.96</td>
<td>3.30</td>
</tr>
<tr>
<td>CAGR/Ann. Std. Dev.</td>
<td>131.52</td>
<td>292.48</td>
<td>228.79</td>
<td>62.18</td>
<td>-61.28</td>
</tr>
</tbody>
</table>

Source: S&P Dow Jones Indices, Barclays Capital. Data as of Dec. 31, 2013. CAGR – Compound annual growth rate. Tables are provided for illustrative purposes. Past performance is not a guarantee of future results. This chart may reflect hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

Exhibit 3: Correlation of Daily Total Returns Over Five Years

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P BDC</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>0.80</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P MLP</td>
<td>0.64</td>
<td>0.68</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P U.S. REIT</td>
<td>0.75</td>
<td>0.81</td>
<td>0.52</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>BarCap Agg.</td>
<td>-0.23</td>
<td>-0.36</td>
<td>-0.19</td>
<td>-0.19</td>
<td>1.00</td>
</tr>
</tbody>
</table>


Exhibit 4: BDC Yields vs. Stocks, Bonds, and Other High-Yielding Equity Categories

The S&P BDC Index constituents meet minimum market cap and liquidity requirements, and the index uses a modified market cap weighting scheme.

Source: S&P Dow Jones Indices, Barclays Capital. Data as of Dec. 31, 2013. Equity index yields calculated as trailing-12-month cash distributions over ending index value. Bond index yield calculated as yield to worst as reported by Barclays Capital for the U.S. Aggregate Index. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.
The S&P BDC Index

The S&P BDC Index tracks leading BDCs that trade on major U.S. exchanges. Its constituents meet minimum market capitalization and liquidity requirements, and it uses a modified market-cap weighting scheme. Modifications are made to market-cap weights, if needed, in order to reflect available free float and apply single-stock capping to mitigate concentration risk.

Selecting and Weighting Constituents

The index is constructed using the subsequent principles.

- **Annual Review:** Every September, the index composition is reviewed to update membership relative to the BDC universe and rules.
- **Membership:** To qualify for index membership, an issue must:
  - Be a publicly traded BDC investment company, as specified in SEC filings;
  - Be listed on a major U.S. exchange; and
  - Meet liquidity and market-cap criteria.
- **Quarterly Rebalancing:** Constituent weights are reset each quarter by float-adjusted market cap. BDCs with weights over 10% are capped at 10%, and excess weight is redistributed proportionally to all uncapped issues in the index.

Number of Constituents

As of Jan. 31, 2014, the index had 34 constituents. The index does not have a set number of constituents, but rather the quantity changes based on how many companies are eligible at each annual review.

Constituent Breakdown by Size

As of Jan. 31, 2014, the weighted average market cap of index constituents was USD 1.9 billion, the median market cap was USD 527.5 million, and market caps ranged from USD 93.8 million to USD 5.2 billion. However, there is no specific target for size distribution in the index. Therefore, these measurements will change over time.

Additions and Deletions

The index is reviewed annually and rebalanced quarterly. Throughout the year, constituents may be removed due to corporate events such as mergers, acquisitions, takeovers, or delistings. There are no intra-year additions to the index.

The complete methodology is available on the web at [http://www.spdji.com/](http://www.spdji.com/).

<table>
<thead>
<tr>
<th>Index Name</th>
<th>Bloomberg Ticker</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P BDC Index</td>
<td>SPBDCUP</td>
</tr>
<tr>
<td>S&amp;P BDC Total Return Index</td>
<td>SPBDCUT</td>
</tr>
<tr>
<td>S&amp;P BDC Net Total Return Index</td>
<td>SPBDCUN</td>
</tr>
</tbody>
</table>
References

Performance Disclosure

The S&P MLP Index was launched on Sept. 6, 2007, at market close. All information presented prior to the Launch Date is back-tested. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. Complete index methodology details are available at www.spdji.com.

The S&P BDC Index was launched on Dec. 5, 2013, at market close. All information presented prior to the Launch Date is back-tested. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. Complete index methodology details are available at www.spdji.com.

S&P Dow Jones Indices defines various dates to assist our clients in providing transparency on their products. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the Index is set at a fixed value for calculation purposes. The Launch Date designates the date upon which the values of an index are first considered live; index values provided for any date or time period prior to the index’s Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company’s public Web site or its datafeed to external parties. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed “Date of Introduction”) is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the Index’s public release date.

Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities (or fixed income, or commodities) markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

Additionally, it is not possible to invest directly in an Index. The Index returns shown do not represent the results of actual trading of investable assets/securities. S&P Dow Jones Indices maintains the Index and calculates the Index levels and performance shown or discussed, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the Index or investment funds that are intended to track the performance of the Index. The imposition of these fees and charges would cause actual and back-tested performance of the securities/fund to be lower than the Index performance shown. For example, if an index returned 10% on a US $100,000 investment for a 12-month period (or US$ 10,000) and an actual asset-based fee of 1.5% was imposed at the end of the period on the investment plus accrued interest (or US$ $1,650), the net return would be 8.35% (or US$ $8,350) for the year. Over a three-year period, an annual 1.5% fee taken at year end with an assumed 10% return per year would result in a cumulative gross return of 33.10%, a total fee of US$ 5,375, and a cumulative net return of 27.2% (or US$ 27,200).
Disclaimer

Copyright © 2014 by S&P Dow Jones Indices LLC, a subsidiary of McGraw Hill Financial, Inc. and/or its affiliates. All rights reserved. Standard & Poor's, S&P and S&P 500 are registered trademarks of Standard & Poor's Financial Services LLC (“S&P”), a subsidiary of McGraw Hill Financial, Inc. Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”). Trademarks have been licensed to S&P Dow Jones Indices LLC. Redistribution, reproduction and/or photocopying in whole or in part are prohibited without written permission. This document does not constitute an offer of services in jurisdictions where S&P Dow Jones Indices LLC, Dow Jones, S&P or their respective affiliates (collectively “S&P Dow Jones Indices”) do not have the necessary licenses. All information provided by S&P Dow Jones Indices is impersonal and not tailored to the needs of any person, entity or group of persons. S&P Dow Jones Indices receives compensation in connection with licensing its indices to third parties. Past performance of an index is not a guarantee of future results.

It is not possible to invest directly in an index. Exposure to an asset class represented by an index is available through investable instruments based on that index. S&P Dow Jones Indices does not sponsor, endorse, sell, promote or manage any investment fund or other investment vehicle that is offered by third parties and that seeks to provide an investment return based on the performance of any index. S&P Dow Jones Indices makes no assurance that investment products based on the index will accurately track index performance or provide positive investment returns. S&P Dow Jones Indices LLC is not an investment advisor, and S&P Dow Jones Indices makes no representation regarding the advisability of investing in any such investment fund or other investment vehicle. A decision to invest in any such investment fund or other investment vehicle should not be made in reliance on any of the statements set forth in this document. Prospective investors are advised to make an investment in any such fund or other vehicle only after carefully considering the risks associated with investing in such funds, as detailed in an offering memorandum or similar document that is prepared by or on behalf of the issuer of the investment fund or other investment vehicle. S&P Dow Jones Indices LLC is not a tax advisor. A tax advisor should be consulted to evaluate the impact of any tax-exempt securities on portfolios and the tax consequences of making any particular investment decision. Inclusion of a security within an index is not a recommendation by S&P Dow Jones Indices to buy, sell, or hold such security, nor is it considered to be investment advice.

These materials have been prepared solely for informational purposes based upon information generally available to the public from sources believed to be reliable. No content contained in these materials (including index data, ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse-engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Dow Jones Indices. The Content shall not be used for any unlawful or unauthorized purposes. S&P Dow Jones Indices and its third-party data providers and licensors (collectively “S&P Dow Jones Indices Parties”) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Dow Jones Indices Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON AN “AS IS” BASIS. S&P DOW JONES INDICES PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT’S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Dow Jones Indices Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P Ratings Services reserves the right to assign, withdraw or suspend such acknowledgement at any time and in its sole discretion. S&P Dow Jones Indices, including S&P Ratings Services, disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

Affiliates of S&P Dow Jones Indices LLC may receive compensation for its ratings and certain credit-related analyses, normally from issuers or underwriters of securities or from obligors. Such affiliates of S&P Dow Jones Indices LLC reserve the right to disseminate its opinions and analyses. Public ratings and analyses from S&P Ratings Services are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P Rating Services publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

S&P Dow Jones Indices keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P Dow Jones Indices may have information that is not available to other business units. S&P Dow Jones Indices has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

In addition, S&P Dow Jones Indices provides a wide range of services to, or relating to, many organizations, including issuers of securities, investment advisers, brokers-dealers, investment banks, other financial institutions and financial intermediaries, and accordingly may receive fees or other economic benefits from those organizations, including organizations whose securities or services they may recommend, rate, include in model portfolios, evaluate or otherwise address.