What are Non-Traded Business Development Companies (BDCs)?

A non-traded BDC is a closed-end fund that provides financing primarily to U.S.-based companies that are not large enough to secure funding from (or otherwise do not have access to) banks or other traditional lenders. They give investors the ability to invest in private companies and offer the potential for higher yields (or income), lower volatility, and diversification when compared to public fixed income. Non-traded BDCs are not traded on an open exchange and are available to investors that meet certain suitability requirements.[1]

WHY WERE THEY CREATED?

BDCs were created as a result of the Small Business Investment Act of 1980 and initially were designed to help small and middle market companies gain access to capital. Increasingly, large companies are borrowing from private lenders due to their ability to offer speed, flexibility, and certainty of execution that traditional banks often cannot, particularly in challenging market conditions.

BDCs must invest at least 70% of their total assets in qualifying assets, which are generally defined as private U.S. companies or public U.S. companies with a market capitalization of less than $250 million.[2] They elect to be subject to regulation under certain provisions of the Investment Company Act of 1940, and generally operate as a Regulated Investment Company (RIC)[3] for U.S. tax purposes, which requires 90% or more of its annual net income and capital gains to be distributed to shareholders. Qualifying as an RIC exempts the BDC from federal corporate level taxes on distributions to shareholders.

HOW ARE THEY STRUCTURED?

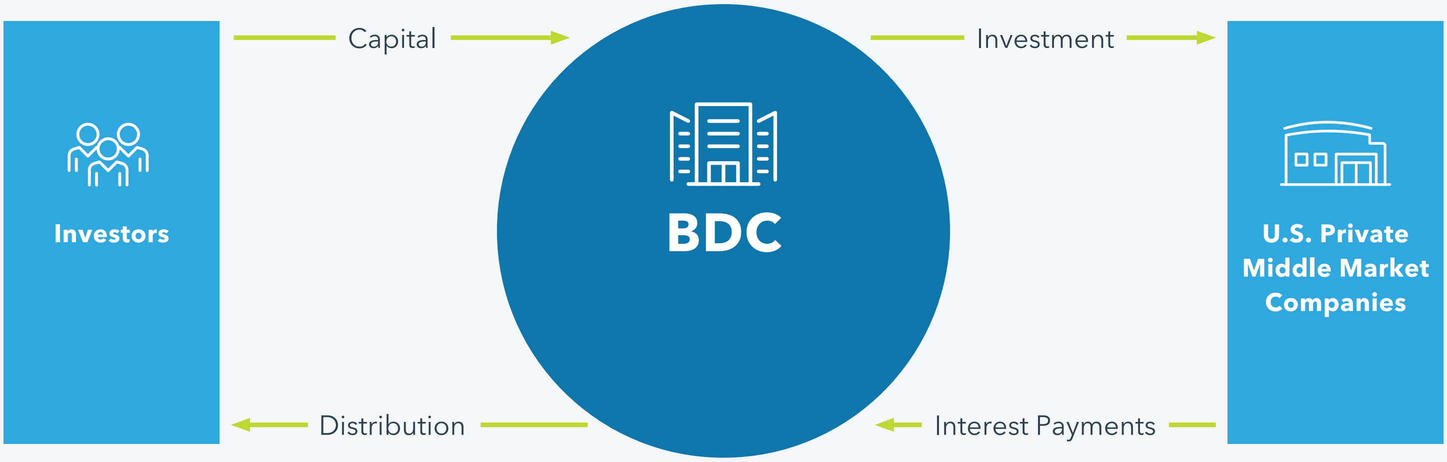
There are three types of BDC structures.

	Public BDCs	Non-Traded BDCs	Private Placement BDCs
Type of Offering	Traditional IPO	Continuous offering	Finite offering
Funding	Real time via a public exchange	Upfront contribution	Capital call model
Liquidity	Real time via a public exchange	Periodic share repurchases, typically up to 5% NAV	Generally, no liquidity until IPO or other liquidity event
Term	At investor discretion	Can be perpetually non-traded or pursue an IPO	Pursue an IPO or contemplate wind down (typically after 5-10 years)

WHAT IS THE PROCESS FOR INVESTING IN UNDERLYING COMPANIES?

While non-traded BDCs can have some equity exposure, the majority are focused on debt through middle market direct lending. The primary investment objective is to generate income; and that income is created through debt payments from loans that can span senior secured debt, subordinated debt, or unsecured debt. The capital and managerial assistance[4] provided to the underlying companies by BDCs aids their advancement and future development. Many of the underlying companies may also be supported by a private equity sponsor (sponsor-backed), supplying additional capital and operational oversight.

THE INVESTMENT CYCLE OF A BDC



BENEFITS

- **Access at Low Investment Minimums:** Unique private credit investment opportunities with investment minimums as low as $2,500.
- **Income Potential:** Focus on higher yields and must distribute 90% of their annual taxable income to investors to qualify as an RIC and avoid federal corporate income taxes.
- **Use of Floating Rate Instruments:** Typically offered with interest payments at a spread above a floating reference rate and a floor on minimum rate, reducing interest rate risk for investors and providing protection in an inflationary environment.
- **Periodic Liquidity:** Generally, non-traded BDCs offer investors quarterly share repurchases (typically up to 5% of the NAV of the fund).[5]
- **Transparency:** Value their assets monthly or quarterly and file periodic reports with the SEC (e.g., Form 10-K, 10-Q, and 8-K), giving investors a transparent view of the holdings.
- **Simplified Tax Reporting:** Issue a Form 1099 instead of a Schedule K-1.

KEY RISK CONSIDERATIONS

Key risk considerations may include, but are not limited to, the following:

- **Manager Selection:** Not all fund managers are the same. The experience, skill level, size of team, assets under management, and track records of managers are all key factors to consider when investing in a non-traded BDC. It is critical to have a thorough diligence process in place to evaluate managers and their ability to operate in challenging environments.
- **Liquidity:** While non-traded BDCs generally offer quarterly share repurchases, the number of shares eligible for repurchase may be limited and subject to other restrictions. In addition, private placement BDCs are considered longer-term investments, with investment terms ranging from 5-10 years (or longer).
- **Fees:** Most non-traded BDCs charge an annual management fee of 0.75%-1.25% of net assets. Fund managers may also charge a performance fee (typically ranging from 12.5%-15%), subject to a hurdle rate (typically 5%-6%).
- **Credit and Default Risk:** Non-traded BDCs may at times invest in the debt of developing and/or financially distressed companies and are subject to credit and default risk.
- **Leverage:** Non-traded BDCs often use leverage, typically ranging from 0.75-1.25x NAV (but not exceeding 2x of NAV), which offers the potential for higher yields, but can also increase the downside risk.

Please contact your financial professional or a fund manager to learn more.

ENDNOTES

1. Suitability standards may vary by state, but generally require an investor to have: 1) a net worth of at least $250,000; or 2) a gross annual income of at least $70,000 and a net worth of at least $70,000.
2. U.S. Securities and Exchange Commission, Definition of Eligible Portfolio Company: Amendment to Rule 2a-46 under the Investment Company Act, May 19, 2008.
3. An RIC is able to pass through taxes for capital gains, dividends, or interest earned to individual investors avoiding double taxation (at both the fund and investor level).
4. BDCs are required to make available "significant managerial assistance" to their portfolio companies that are qualifying assets under the Investment Company Act of 1940.
5. The Fund Board can decide to suspend share repurchases at any time.

DEFINITIONS

Hurdle Rate: The minimum return investors must receive before the fund manager earns performance fees.
Senior Secured Debt: Debt backed by specific assets or collateral, which generally sits atop a company's capital structure. If a borrower defaults, the lender can seize those assets or collateral to repay the debt and is usually first in line to be repaid in the case of a default. Senior secured debt is typically comprised of a 1st and possibly 2nd lien loan.
Subordinated Debt: Debt that ranks below more senior debt, which would be paid after all senior debt in the case of a default.
Unsecured Debt: Debt not backed by assets or collateral with no guarantee to the lender that they will be paid in full.

iCapital®

60 East 42nd Street, 26th Floor
New York, NY 10165
212.994.7400

www.icapital.com

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