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Don't Invest In BDCs Without Reading This First...

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Business development companies let you invest like the mega-rich. Here's what you must know before you jump in...

If *Frankenstein* author Mary Shelley had been an investment fanatic, she might've liked the idea of the Business Development Company (BDC): Fashion a company out of parts of other companies, then set the creation loose by taking it public.

Of course, society doesn't shun the BDC as it did Victor von Frankenstein's monster, nor has Mel Brooks made a comedic movie about the investment (though that would be cool). In fact, BDCs can be gentle giants.

But before you invest in one, it's best to understand a few key terms, lest you wake one night to a financial monster staring back at you.

Business Development Company (BDC)

First things first: What is a BDC? It's basically a private equity or venture capital firm that goes public. It uses the proceeds of the public offering to invest (typically) in small- or medium-size private companies... but it can't invest in just any company.

The goal is to invest in new companies and provide guidance. As such, a BDC must control the issuers it invests in or it must provide "significant managerial assistance" (which could include holding board seats or simply providing consulting guidance). This often means that entrepreneurs and managers give up some control over their businesses.

#-ad_banner-#Similar to common stocks, BDCs usually trade on one of the major U.S. exchanges. However, unlike regular stocks, they represent a share of a specialized portfolio managed by a group of advisors concentrating on a specific industry, country or sector. Deciding which companies to invest in requires reviewing hundreds of business plans, meeting company managers and performing extensive due diligence on investments.

The Investment Company Act of 1940 and the SEC regulate BDCs; they got a boost after the passage of the Small Business Investment Incentive Act in 1980. These regulations cover everything from what the BDC can invest in to who can be on the board. Most BDCs have Regulated Investment Company (RIC) status, which means they generally must distribute at least 90% of their taxable income to shareholders every year.

This RIC status also requires BDCs to stay diversified: They usually can't put more than 5% of their assets in any single security (and we're not just talking about equity securities); they usually can't buy more than 10% of any issuer's voting securities; and they usually can't put more than a quarter of their assets into businesses that they control or businesses that are in the same industry. (Note: This does not apply to investments in U.S. government securities or other registered investment companies.)

A BDC is a corporation and has a board of directors. The investment managers of a BDC operate according to an investment advisory agreement and receive a fee every year -- typically 2% of the BDC's assets, but it varies. They also receive a performance fee that depends on the amount of interest income, dividend income and capital gains the BDC earns.

Venture Capital and Private Equity

BDCs are similar to venture capital (VC) or private equity (PE) funds in that they provide investors with a way to invest in small, private or other hard-to-access companies that typically have less access to capital markets. However, VC and PE funds are often open only to wealthy, sophisticated investors, as well as investment banks, endowments, pension funds, insurance companies, various financial institutions and other corporations. BDCs allow regular investors a way in.

BDCs also offer more liquidity than VC and PE funds. Investors no longer have to wait for the investment managers to liquidate the BDC's investments in the underlying companies; they can simply sell their shares in the open market. This feature often attracts money quickly to new BDCs, making BDCs an often faster way to raise private equity and venture capital for small and medium-sized companies.

Registered Investment Advisor

In general, BDC investment managers must be registered investment advisors with the SEC. Registered investment advisors provide advice about investments for a fee and are required by most states to register or become licensed. This usually involves passing the Series 63, 65 and/or 66 tests administered by FINRA. Registered investment advisors must make regular filings to state and federal agencies, pay processing fees, maintain minimum net capital and ensure that their employees are properly licensed as well.

Harvesting

One of the most important parts of BDC investing is the "exit" -- the plans for selling an investment in a company. Also known as the "harvest" or "liquidity event," the exit takes place anywhere from three to 10 years after the initial investment, often via an initial public offering of the underlying company or through the merger or sale of the underlying company.

Though this is the stage at which shareholders hopefully make a lot of money -- and it is tempting to malign this influx of profit as "vulture-like behavior" -- it is important to realize that BDCs provide important and necessary investments. They foster entrepreneurship, help struggling companies get badly needed cash to turn themselves around, and even provide managerial expertise to give those turnarounds the best chance they can.

This, of course, is not without tremendous risk. Many companies fail or underperform, which is why BDCs diversify their investments. Nonetheless, BDC investors must be willing to take significant long-term risks for what can be very high returns.

The Investing Answer: Business Development Companies are public corporations that invest in other companies. They are subject to significant regulations that can affect what you, the investor, receive in dividends and returns, and they sometimes take on some considerable risks when they invest in companies that are young, small, private, struggling or developing. With risk comes opportunity, of course.

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