Secret Savers 7% Account

The Dividend Hunter

Investors Alley
Introduction

By Tim Plaehn

By deciding to read this special investment research report you’re taking a step in the right direction to secure your financial independence in a way that is meaningful and real. You’re devoting the necessary time—however brief—to creating growing and enduring wealth. And while there are many ways to create wealth, earning a steady and high rate of return on your money has traditionally been one preferred by income investors.

In this report, I’ll share with you a special type of finance that frankly most Americans are completely unaware of, yet if they were, they could get yields of 7%, 10%, or even higher instead of the paltry 1% - 1.5% on offer from the megabanks. Even credit unions—the financial institutions for savers and workers—offer very little return for your money these days.

Then we’ll discuss the one of these firms that I feel every person looking for extra income—and monthly income at that—needs to give serious consideration to. Since adding it to the portfolio more than a year and a half ago it’s already repaid my readers with a 13.24% cash return. Compare that to the 1% your bank offers.

Then I’ll share with you two more investment ideas from the same space. One of them is another holding in The Dividend Hunter portfolio and the other is perfect if you’re looking for the combination of high yield now and the opportunity for high stock price growth later on.

And lastly, I’ll share with you some names to avoid. These are the ones that look great when the economy is doing well, but will sell off hard and potentially slash dividends at the first hint of trouble.

Please enjoy this new report with my compliments.
What are Business Development Companies?

A close look at a business development company (BDC) shows a company or stock that combines the features of a finance company, an income fund, and a venture capital fund. BDCs operate under special tax rules and laws that were written to provide debt and equity capital to corporations that are too small to access the public stock and bond markets. The business of a BDC is to make loans and/or equity investments to mid-sized corporations.

Legally, a BDC is a closed-end investment company that is similar to closed-end mutual funds (CEF). The difference is that a CEF owns publicly traded stock shares and bonds, while a BDC makes direct investments into its client companies. A BDC will have up to hundreds of outstanding investments to spread the risk across many small companies. The client companies of a BDC will be corporations that are too small or too new to be able to issue stock or bonds into the publicly traded markets.

As a risk control factor, BDCs are limited to no more than one times its equity in leverage. This means that if a BDC has $500 million of equity raised from selling shares, it can borrow another $500 million. The company can then make $1 billion of loans or equity investments. This helps avoid many of the problems we saw from other firms during the 2008 financial crisis.

Again, by law, a BDC must operate as a pass-through entity, paying at least 90% of net income out as dividends to shareholders. There are several consequences of a pass-through business structure. First, and very importantly, these companies do not pay corporate income taxes. (Real estate investment trusts (REITs), mutual funds, and exchange traded funds (ETFs) are other types of pass through business entities.) No income taxes and the 90% payout rule place BDCs squarely into the high-yield income stock category. Typical BDC yields range from high single digits up to low double digits. A company operating on a pass-through model grows by issuing more shares and/or debt and then uses the new capital to make more investments.

As investors, we want to see the companies behind our high-yield stocks be able to make "accretive" investments when they sell more shares into the market. Accretive means that the company will earn a higher yield on the investments it makes than the current yield on the stock shares. The extra earnings will help the company grow the dividend: the importance of this cannot be understated to investors planning to live off investment income. In the BDC universe, a stock price that is above its net asset value (NAV) is a good indicator that the company can grow distributable cash flow when it issues new stock shares.
Management fees are a big deal with BDCs and you’ll want to pay close attention to them when evaluating any BDC for your own portfolio. Most of the companies in the sector have external management agreements, where a larger financial firm provides the management services for the BDC. The typical management agreement pays a percentage of assets and a cut of profits after the portfolio yield exceeds a certain level. The costs on an externally managed BDC are usually higher than the average management expenses of the handful of internally managed business development companies. It is not uncommon for the management fee to scrape off 3% of assets, which is a direct reduction of the income yield available to pay dividends to investors.

It is important to keep in mind that BDCs are companies with low to medium credit ratings borrowing money and selling shares so they can lend to smaller companies with worse credit metrics. The result is that the major risk to BDCs is a negative economic credit event that would prevent BDCs from borrowing or refinancing and at the same time, causes the portfolio clients to default on their obligations to pay the BDCs. Such an event occurred in the form of the 2008-2009 financial crisis and the surviving BDCs claim to have learned their lesson.

A large portion – about half – of the 40 public BDCs are mostly indistinguishable from each other. Venture capital and leveraged buyout firms are a major source of BDC client companies. These firms feed the debt financing business to the BDCs to get the loans necessary to grow or buyout the medium sized companies stalked by the venture capital types. This group of BDCs will do fine as long as the economy remains stable and the individual companies do not reach too deep into the junk credit drawer in a stretch for portfolio yield.

Reviewing individual BDCs by scrutinizing the negative factors leaves a very small number of companies that meet The Dividend Hunter standards for yield, dividend growth, and safety. Let’s start with the first one which gave this report, Secret Savers 7% Account, the basis for its name.
Main Street Capital (NYSE: MAIN)

Our BDC portfolio selection, Main Street Capital Corp. (NYSE: MAIN), really is quite different from the rest of the BDC crowd. Since its 2007 IPO, MAIN has doubled the total return of a BDC index. MAIN is internally managed with insiders owning about 2.9 million shares. Co-founder, Chairman and CEO Vince Foster is the single largest individual shareholder. Main Street is the most conservatively managed company in the BDC sector. Here are some of the factors that set the company apart:

- An investment grade BBB credit rating. Investment grade is rare among the BDC crowd and it allows Main Street to borrow at a much lower cost of capital compared to its peers.

- Operating, administration and management costs are 1.4% of assets compared to 3.4% for the average BDC and 2.7% for commercial banks.

- Net debt is just 0.68 times NAV

- The share price is about 1.5 times the book or NAV value.

MAIN uses a two-tier approach to its portfolio. This unique strategy allows Main Street to generate a high level of interest income and capital gains from equity investments. In the middle market, MAIN provides debt financing to companies with stable finances and low risk of default. Currently Main Street has 81 middle market clients with an average loan amount of $8.1 million. The loans total over $630 million or about 33% of MAIN's total portfolio. Middle market loans are floating rate, and matched with MAIN's floating rate debt facility. The average 8.4% yield on this group of loans is about 5% higher than the Main Street's debt used to fund the loans to clients. The 5% interest margin is almost pure cash flow that can be used to help pay dividends on MAIN's stock shares, translation: more money to us investors.

In the other tier, lower middle market, or LMM, the company takes equity stakes along with providing debt financing. The equity provides a significant boost to the total returns generated. Lower middle market companies are smaller than the typical BDC client. These are companies with annual revenues between $10 and $150 million and there are over 175,000 of these companies in the U.S. Currently, MAIN has about 71 lower middle market clients with loans and equity investments worth about $830 million. Seventy percent of the investments are loans with an average yield of 12.5%. The 30% of the LMM portfolio in equity positions gives an average 36% ownership of the
client companies. The equity stakes are what have allowed the MAIN NAV to increase by 65% since the 2007 IPO.

Below is a breakdown of where MAIN puts its money to work.

In 2015, MAIN grew the size of its investment portfolio by 15% to $1.8 billion. As the best managed, lowest cost BDC, MAIN will be able to maintain its share value and distribution growth trajectory the company has produced over the last half decade.

The lower middle market client and middle market client mix provides a combination of net interest income to support MAIN's excellent history of dividend payments. The result has been a BDC that has generated both regular dividend growth for investors and special dividends to pay out capital gains. As an additional bonus, MAIN pays monthly dividends, smoothing out the cash flow into your brokerage account. To illustrate, the chart at the top of the next page shows the historical dividend payments to MAIN shareholders, including regular dividend payments and special “extra” dividends, noting with SP below them.
In September 2016, the monthly dividend was increased by 1/2 cent to $0.185. That is a 2.7% increase over the last rate. At $36.15 per share as of this writing, MAIN yields 5.94%. Also, the company has been paying a special dividend twice a year to pay out some of the profits from the lower middle market equity investments. Over the last year, the two payments have totaled $0.55 per share, bringing the total yield to just over 8%.
MAIN generates a significant cash flow cushion to cover the dividends to be paid. This is a very important factor for us when considering which stocks to add to the portfolio. As of September 2016, the distributable net investment income was $2.37 per share. This is interest income only, no capital gains, and provides 1.10 times coverage for the monthly dividend. The high share price to book value ratio (about 1.5 times) for Main Street allows the company to sell shares and generate an immediate positive result for investors. This capital can then be put to work to generate a growing cash flow stream to support future dividend increases.

A Couple of Other Interesting BDC Choices

Main Street Capital really does stand out from the crowd in the BDC space. However, there are other gold nuggets among the rocks that make up the rest of the group. Here are two more:

**Hercules Capital (NYSE: HTGC)** has carved out its own unique niche. HTGC is one of the oldest BDCs, founded in 2003 and came into the market with a 2005 IPO. Until recently, the firm was known as Hercules Technology Growth Capital.

The company is internally managed with a $1.1 billion market cap. In the BDC world, $850 million, with a $1.66 billion enterprise value (market cap plus debt) is one of the larger companies. What sets HTGC apart from its peers is its client focus. Hercules works with venture capital and private equity firms to provide funding for companies that are pre-IPO or being groomed for merger or acquisition. The BDC focuses on providing funding primarily to various types of technology related companies. To assist its client companies and their venture capital backers, HTGC makes only senior debt loans with maturities of 3 to 3 1/2 years. About 90% of Hercules' assets are loans with 10% as equity positions that can pay off very well when a client goes public or is acquired. Those positive outcomes occurred with a significant portion of the HTGC portfolio in 2014 and early 2015. Currently, the company is "reloading" its portfolio with future growth prospects. Dividend growth has stalled during this reloading period, but investors can expect future dividend increases. Current yield is 8.86%.

**TriplePoint Venture Growth BDC Corp (NYSE: TPVG)** is a small-cap BDC that came to market with a March 2014 IPO. This $195 million market cap BDC can almost be viewed as a mini-HTGC. The company makes loans to companies backed by a select group of leading venture capital investors with a focus on technology, life sciences, and other high growth industries. Extra growth potential for additional return comes through equity “kickers” in the form of warrants. In its short life, TPVG has increased its dividend rate twice and paid two special dividends. Current yield is 11.78%.
BDCs to Avoid

In general, business development companies that meet my criteria of financial stability and potential for long-term dividend growth are a very small number out of the larger pack. Here are a few that are at the back of the pack due to lack of dividend coverage with income earnings and/or falling NAV values.

Apollo Investment (Nasdaq:AINV)

KCAP Financial (Nasdaq:KCAP)

PennantPark Investment Corp. (Nasdaq:PNNT)