

Sector Insights

Business Development Companies: Risk beyond the yield

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Summary

Heightened market volatility has increased the importance of understanding how business development company, or BDC, risk evolves across the cycle. This analysis examines key drivers within the Financials sector — including credit quality, net asset value (NAV) behavior, dividend dynamics, portfolio composition, and access to capital to assess how BDC risk profiles shift as uncertainty rises and credit conditions evolve.

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Why volatility matters

Business Development Companies, or BDCs, often attract heightened attention during periods of market volatility, particularly when income-oriented investors are focused on yield. While we actively cover the BDC sub-sector, our current view remains unfavorable, and we are not recommending individual stocks at this time. Instead, we believe the most productive conversation for investors today centers on understanding the fundamental drivers and risks shaping the Financials sector, especially as volatility persists and credit conditions evolve.

Volatility changes the risk equation

BDCs are structurally unique vehicles that combine exposure to private and middle market credit, meaningful balance sheet leverage, and public equity market pricing and liquidity. During stable markets, these features can work together constructively. In volatile markets, the same structure can magnify downside risk.

Market volatility often impacts BDCs in a non-linear way — meaning equity prices react quickly while underlying credit fundamentals typically adjust with a lag, as is the case in the current environment. As a result, reported earnings and NAVs can appear resilient even as borrower stress begins to build beneath the surface.

This timing mismatch is one of the key reasons we emphasize fundamentals over near-term performance metrics in the current market.

Core BDC fundamentals

At this stage of the cycle, evaluating BDCs requires a focus on the core drivers that ultimately determine performance. Credit quality, asset valuation, income durability, and portfolio structure tend to matter more than headline yield or short-term earnings momentum. These fundamentals also tend to become more differentiated as volatility increases and dispersion across borrowers widens.

Credit quality

Credit quality remains the primary driver of long-term outcomes for the BDC sub-sector. While higher rates have supported asset yields, they also increase interest burdens for middle market borrowers — many of which operate with less operating flexibility than larger corporates. Slower growth, tighter financial conditions, and refinancing risk can pressure borrower cash flows over time.

Importantly, credit stress tends to emerge gradually. Early warning signs may not immediately translate into non-accruals or realized losses, but they can shape future portfolio performance. For this reason, credit analysis is particularly critical when market conditions are unsettled.

NAV dynamics

Net asset value is often viewed as a signal of balance sheet health, but NAV stability during volatile periods does not necessarily imply low risk. BDC assets are illiquid and marked infrequently, which can smooth NAV movements in the short term. Credit deterioration, when it occurs, often shows up later through incremental valuation changes or realized losses.

Key takeaways

Volatility often exposes risk before credit stress appears in fundamentals.

Headline yield can mask rising underlying credit risk.

As volatility persists, NAV should be considered alongside broader credit trends and portfolio composition rather than viewed in isolation. Changes in NAV tend to become more meaningful once credit issues are clearly visible.

Income and dividend sustainability

Dividend income is a central feature of BDCs, but sustainability depends on the quality and durability of earnings. In the current environment, dividend coverage ratios may benefit from floating-rate tailwinds, fee income, or Paid-in-Kind (PIK) interest, all of which warrant closer examination.

Most BDC loans are floating rates, which boosts net investment income when short-term rates rise. While this has supported coverage over the past several quarters, it can mask early credit pressure and may prove temporary as rates stabilize or borrower cash flows tighten. Income from prepayment fees, structuring fees, and other episodic sources can lift earnings in certain periods but is inherently inconsistent. Relying too heavily on these items can make dividend coverage appear stronger than the underlying recurring income would suggest. Paid-in-Kind income increases accounting earnings but does not generate current cash. A rising share of PIK interest typically indicates borrower stress and can create a disconnect between reported earnings and true cash available to support dividends.

While reported dividend coverage can appear comfortable, it may not fully capture future credit costs or changes in borrower performance. As conditions evolve, the path of income is often influenced as much by credit outcomes as by rate levels, making dividend analysis inseparable from broader fundamental assessment.

Portfolio construction and dispersion

Portfolio construction is a crucial differentiator during volatile markets because not all borrowers or industries respond to stress in the same way. BDC portfolios are diversified, but exposure to certain sectors can create very different performance outcomes. Understanding what a BDC typically lends to — and how those borrowers are affected by economic and technological shifts — helps explain why dispersion tends to widen when conditions get harder.

One important example is software lending. Many middle market software companies rely on recurring revenue models, which can be resilient, but they are not immune to slower customer spending or rising borrowing costs. In today's environment, some software borrowers are also facing artificial intelligence- (AI-) driven disruption, which can pressure margins or delay new customer wins. These dynamics may not immediately show up in credit metrics, but they can influence future performance. BDCs with heavier exposure to cyclical areas can experience faster credit deterioration when economic momentum slows.

Industry differences, combined with variations in loan seniority, covenant protections, and deal structures, means that portfolio composition can significantly shape outcomes during volatile periods. As dispersion increases, broad sector averages become less representative of the underlying risks within individual BDC portfolios.

Capital markets and balance sheet flexibility

Access and flexibility are critical considerations for BDCs, particularly in scenarios where asset values come under pressure. While credit performance typically drives longer term outcomes, the ability to manage leverage and funding during periods

Key takeaways

- Floating-rate exposure boosts earnings, as higher rates temporarily lift dividend coverage.
- Fee income is episodic and can inflate dividend coverage without improving long-term sustainability.
- Paid-in-Kind income boosts reported earnings, not cash flow and a greater reliance on PIK can weaken true dividend support.

of stress can meaningfully influence near-term risk. Limited access to capital may force difficult trade-offs, including reduced investment pace, higher funding costs, or asset sales at unfavorable prices.

What we are watching

Given the current environment, we remain focused on indicators that can signal improving risk-reward dynamics for the Financials sector. These include stabilization in borrower fundamentals, greater clarity around credit performance, improved capital markets conditions, and reduced volatility across broader markets. Until visibility improves, we believe discipline and a focus on fundamentals are especially important when evaluating credit-sensitive income strategies.

Financials sector equity recommendations

Ticker	Company name	Market cap (billions)	Price	Dividend	Dividend yield	Estimated NTM EPS	NTM P/E	Core	DSIP	Growth	Focus	High Yield	SMID	Value
AFL	Aflac Incorporated	\$55.36	\$113.07	\$2.32	2.1%	\$7.45	15.2x		X					
AON	Aon Plc Class A	\$68.87	\$325.40	\$2.91	0.9%	\$19.66	16.5x							X
AXP	American Express Company	\$206.15	\$317.77	\$3.28	1.0%	\$18.18	17.5x							X
BLK	BlackRock, Inc.	\$160.11	\$1,001.62	\$20.84	2.1%	\$55.93	17.9x	X	X		X	X		
BRK.B	Berkshire Hathaway Inc. Class B	\$1,027.30	\$485.20	\$0.00	0.0%	\$20.86	23.3x	X			X			
BRO	Brown & Brown, Inc.	\$21.89	\$67.13	\$0.62	0.9%	\$4.63	14.5x		X					X
BX	Blackstone Inc.	\$132.47	\$116.90	\$4.69	4.0%	\$6.65	17.6x	X						
C	Citigroup Inc.	\$200.26	\$124.92	\$2.32	1.9%	\$10.74	11.6x					X		X
CB	Chubb Limited	\$126.10	\$332.94	\$3.82	1.1%	\$27.32	12.2x	X	X					X
CBSH	Commerce Bancshares, Inc.	\$7.13	\$51.19	\$1.04	2.0%	\$4.05	12.6x		X					
CPAY	Corpay, Inc.	\$19.86	\$306.57	\$0.00	0.0%	\$26.91	11.4x			X			X	
FDS	FactSet Research Systems Inc.	\$7.19	\$213.52	\$4.34	2.0%	\$18.37	11.6x		X				X	X
ICE	Intercontinental Exchange, Inc.	\$89.06	\$161.97	\$1.92	1.2%	\$7.91	20.5x		X					
JKHY	Jack Henry & Associates, Inc.	\$11.36	\$153.38	\$2.32	1.5%	\$7.05	21.7x		X				X	
JPM	JPMorgan Chase & Co.	\$796.76	\$310.33	\$5.80	1.9%	\$21.97	14.1x	X			X	X		X
KKR	KKR & Co Inc	\$79.27	\$92.83	\$0.73	0.8%	\$6.75	13.8x			X				
MA	Mastercard Incorporated Class A	\$448.37	\$503.57	\$3.15	0.6%	\$20.29	24.8x	X	X		X			
MKL	Markel Group Inc.	\$23.80	\$1,956.63	\$0.00	0.0%	\$117.36	16.7x							X
MS	Morgan Stanley	\$263.03	\$178.16	\$3.85	2.2%	\$11.60	15.4x	X			X	X		
PFG	Principal Financial Group, Inc.	\$19.24	\$92.32	\$3.08	3.3%	\$9.60	9.6x							X
PNC	PNC Financial Services Group, Inc.	\$83.07	\$223.23	\$6.60	3.0%	\$18.80	11.9x				X	X		
SPGI	S&P Global, Inc.	\$122.05	\$424.32	\$3.84	0.9%	\$20.20	21.0x	X	X					
V	Visa Inc. Class A	\$581.16	\$308.29	\$2.44	0.8%	\$13.67	22.5x	X	X		X			
WRB	W. R. Berkley Corporation	\$24.15	\$67.21	\$0.35	0.5%	\$4.62	14.5x		X				X	

Sources: FactSet, Wells Fargo Investment Institute. Prices and data as of April 9, 2026. NTM = next-twelve-months. EPS = earnings per share. P/E = price-to-earnings.

Global Securities Research List Descriptions:

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