

Business development companies: Middle-market financiers of the future?

The middle-market lending environment is undergoing a dramatic shift. This evolution is increasing competition among lenders—and along with that, creating the opportunity for new leaders in this space. Just a few years ago, banks originated most of the commercial loans for the middle-market.¹ Now, nonbank institutions, such as business development companies (BDCs), are taking on a greater share of the lending. In fact, BDCs are transitioning into this role so well that they are envisioned by some as potential financiers of the future for the middle-market.

What are BDCs?

Enabled in 1980 through the Small Business Investment Incentive Act,² BDCs are generally closed-end funds that must invest a certain amount of their assets in eligible portfolio companies, typically US issuers that are either private or have less than \$250 million in market capitalization.³ Their primary value in the marketplace is to provide financing to organizations that may find it difficult to get bank loans or private equity financing. The majority of BDCs elect to be regulated investment companies (RICs) under the Internal Revenue Code, allowing for flow-through tax treatment. Slightly more than 80 percent of BDCs are debt-focused (with the remaining equity-focused); three quarters are managed externally by an outside investment adviser.⁴ BDCs may be listed on an exchange or remain unlisted.

Demand for BDCs is growing, as indicated in Figure 1. Publicly listed BDCs have a market capitalization of \$32 billion and hold \$55 billion in loan balances—numbers growing respectively at compound annual rates of 23 and 28 percent over the past decade.⁵ The number of listed BDCs launched annually has increased to an average of five per year since 2010, up from a two per year average for the prior five-year period.⁶ The US Securities and Exchange Commission (SEC) reports 92 BDCs with an active filing status in 2014, with 55 of these currently listed on a national securities exchange. The remainder represent pending BDCs, inactive companies, and those that have ceased operations or withdrawn their election to be BDCs.⁷ At present, according to SEC filings, there are seven unlisted BDCs, making up a significant share of the overall BDC lending volume.⁸

Three benchmarking indices for BDCs now exist, indicating the level of interest in the BDC marketplace. BDCs have performed well over the longer term, though they have faced short-term challenges. For example, total return for the Wilshire Business Development Company Index was -6.71 percent in 2014, yet with annualized total return of 11.51 percent for the three-year period.⁹

Benefits of BDCs

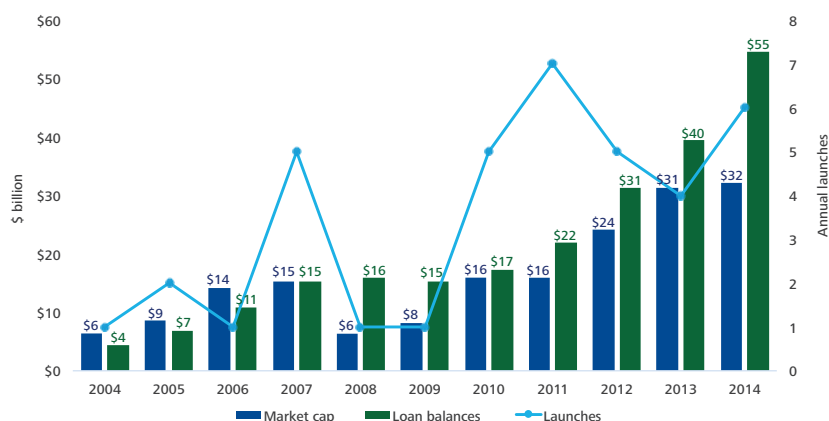
BDCs may provide a number of benefits to their sponsors. These benefits may include access to permanent capital in the case of listed BDCs; the ability to charge performance fees for a retail product; a choice of internal or external management; access to both institutional and retail investors; and input into the portfolio company management.

In turn, investors find BDCs attractive as well. BDCs provide investors with access to illiquid investments in a liquid structure (through traded shares), in addition to flow-through tax benefits if the BDC elects RIC status. BDCs also pay out dividends, averaging 10.3 percent in 2014,¹⁰ making them attractive to income-seeking investors such as retirees.

Growth drivers for BDCs

Recent changes within the middle-market lending business have provided strong impetus for the growing interest in BDCs. New regulations related to higher capital and liquidity requirements, coupled with restrictive regulatory guidance on leveraged lending, are forcing banks to scale back their lending

Figure 1: Growth in BDC market capitalization, loan balances, and launches



Sources: Includes listed BDCs. Data sourced from S&P Capital IQ, February 19, 2015; CEFA's Closed-End Fund Universe, December 31, 2014; Thomson Reuters Markets, September 2014.

to more risky middle-market borrowers.¹¹ As such, oversight around leveraged lending has escalated, and nonbank institutions such as BDCs have started to step up and help fill the void. BDCs are already benefiting from this transition, as the volume of middle-market loans held by BDCs has trended upward over the past five years.¹² Further momentum could come from changes wrought by risk-retention rules in the securitization market, affecting middle-market collateralized loan obligations.

Private equity firms have accounted for the majority of BDCs created over the last few years and have sponsored roughly 95 percent of BDC launches and filings, according to Deloitte Center for Financial Services estimates. The attractiveness of BDCs to private equity managers is based largely on the fact that BDCs offer a more preferable venue for fundraising than other options.

Thus far, bank participation in the BDC market has been limited, with only three bank-affiliated entities filing for—or launching—BDCs. BDCs may attract more attention from banks in the future, as they deal with higher capital and liquidity requirements or are forced to comply with new regulations such as the Volcker Rule, part of the Dodd-Frank Act of 2010. One of the primary stipulations of the Volcker Rule is that banks are prohibited from investing in covered funds, which are hedge funds or private equity funds by definition. Since BDCs and RICs are specifically excluded from the covered fund definition, banks may invest in these investment companies, as long as they do not hold more than 25 percent of voting shares.¹³ In this way, banks may retain their indirect participation in middle-market lending through BDCs.

What should sponsors do?

There are several approaches financial services companies may take in regard to BDC market-entry strategies:

- Launching a BDC (generally in RIC format)
- Acquiring a BDC
- Converting a private fund to a BDC

Each of these options requires special consideration. Important issues for sponsors to consider include a sponsor's existing or potential relationship with supporting financial providers; capability for acquisitions; and desire for BDC sponsorship versus investing through a private fund. Investment managers and banks not currently operating as Investment Company Act of 1940 ('40-Act) managers will have additional considerations related to regulatory and compliance requirements. These may be more challenging than expected, so the need for third-party expertise and guidance may be greater for these companies than for those already operating '40-Act regulated funds.

Regulatory, tax, and valuation considerations

Effectively launching and managing a BDC requires a clear understanding of the regulatory, tax, and valuation considerations that are unique to BDCs. Sponsors need to ask themselves a number of key questions, starting with those outlined in Figure 2. Additional considerations include gaining an understanding of the rules and regulations for each of these

areas, as well as knowing where to start when it comes to forming leading practices.

Regulatory: BDCs have been a focal area for the SEC, as demonstrated by the three guidance updates issued by the SEC in 2014. Broadly, these relate to: modifying conditions on exemptive applications seeking relief to exclude the debt of wholly-owned Small Business Investment Company subsidiaries from the BDC parent's asset-coverage requirements under the '40-Act to only those SBIC subsidiaries that have issued indebtedness that is held or guaranteed by the Small Business Administration; suggesting consolidation of financial statements for BDCs with wholly-owned subsidiaries under certain circumstances, such as where the subsidiary is set up to facilitate investment in a portfolio company; and treatment of certain "close affiliates," namely, limited partners of a private fund that is a close affiliate, in the context of joint transactions.¹⁴

Key considerations for sponsors:

• **Restrictions on asset composition:** A BDC must be operated for the purpose of investing in eligible portfolio companies and (with certain exceptions) make available to them significant managerial assistance. A BDC may not purchase a "nonqualifying" asset unless, at the time of purchase, at least 70 percent of its total assets consists of qualifying assets. These include securities of eligible portfolio companies, cash, US government securities, and high-quality debt and short-term securities maturing in one year or less.

• **Restrictions on transactions with affiliated persons:** BDCs have limitations on transactions with affiliates, including principal underwriters during distributions. Principal or joint transactions involving the BDC and its adviser or close affiliates are generally not permitted, or permitted only if certain requirements are met. Limits could prohibit coinvestments with proprietary or private funds of the same or affiliated adviser. Additionally, there may also be limitations on payments to affiliates for acting as agent.

• **Limitations on leverage and transactions:** A BDC is subject to the '40-Act's limitations on leverage, which generally requires BDCs to maintain a minimum 200 percent asset coverage for debt securities, bank borrowings, and preferred stock.

Tax: While managing a BDC as a RIC provides certain tax advantages, including a dividends-paid deduction that offsets investment company taxable income and the ability to utilize a long-term capital gains tax rate, there are several tax challenges to operating what is essentially a private fund in a RIC wrapper. As BDCs formed as RICs are taxed under Subchapter M of the Internal Revenue Code, sponsors need to confirm that they have strong subject matter specialization to navigate the subtleties of tax law applicable to RICs.

Key consideration for sponsors:

Specialized tax knowledge: One of the primary issues to consider when it comes to BDC taxation is meeting the asset diversification and qualifying income tests that are applicable to RICs. Voting rights, increases in market value while continuing to make new or add-on investments, investing in operating partnerships, and the potential receipt of various types of fee income all require a strong focus on understanding how RIC qualification might be impacted. Sponsors of BDCs who have not previously managed RICs may find these and other tax issues particularly challenging.

Valuation and accounting: BDC valuation is determined according to standards established by the Financial Accounting Standards Board Fair Value Measurements and Disclosures (Topic 820). In practice, holdings in BDCs are valued on a quarterly basis, with fair value determined either by available market quotes or through other fair-value techniques if market values are unavailable. BDCs generally invest in illiquid securities, with the result that sponsors may face more stringent and complex valuation procedures than for more liquid investments. Valuation requires subjective judgments so there can be diversity in valuation practices across sponsors. Over the last year, several areas of diversity in practice have become more evident, such as the treatment of upfront fees, recording and disclosure of unfunded commitments, and consolidation. All of these areas deserve careful consideration and thoughtful disclosure.

Key consideration for sponsors:

Careful accounting: It is important for sponsors to assure leading industry practices in regard to BDC valuation and accounting, particularly as they relate to the use of external parties for valuation. Determining the right discount rate to use in bond valuation is important for BDCs, particularly in situations where a vendor has not been able to provide a price. Additionally, because of their level of participation in the process, educating the board of directors is an important step to assuring compliance with valuation standards.

Risks, challenges, and opportunities for the BDC market

Like every emerging marketplace, BDCs face risks, challenges, and growth opportunities. For example, after three years of robust asset growth, BDCs are facing short-term market pressure. As mentioned above, index performance showed a negative result in 2014, and net asset value growth also declined by -0.41 percent.¹⁵ BDCs were removed from two primary indices in 2014, raising concerns about liquidity of shares and potential increases in the cost of raising equity.¹⁶ Additional concerns have been expressed about BDCs increasing their off-balance sheet risk levels by greater use of senior secured loan programs.¹⁷

The prospects may indeed be bright in the long term. The direction of legislation and regulatory guidance affecting middle-market lending may be considered both a risk and an opportunity for BDCs. It is factoring heavily into the evolution of bank lending to the leveraged segment of the middle-market, which in turn may make BDCs a favorable alternative. Historically, BDCs have sustained a 35-year history of lending, which includes robust recovery from negative market events. Over the past decade, BDCs' share of middle-market lending volume and loan balances continues to grow steadily.¹⁸ Finally, BDCs offer benefits to parties at both ends of the spectrum, with sponsors and investors finding their structure and yields attractive in current market conditions.

It might be too early to say if BDCs will grow to be the financiers of the future for the middle-market. However, based on their potential to provide an alternate exposure to the middle-market, investment managers and banks need to take a closer look at the opportunity. If market events and regulations continue to converge in favor of nonbank lenders, BDCs—and the entities that sponsor them—may find themselves ideally positioned to capitalize on the opportunity.

Figure 2: Regulatory, tax, and valuation considerations for BDCs

Regulatory

- Are we meeting the 70 percent test for qualifying investments?
- Have we identified affiliates accurately?
- Are we in compliance with restrictions on transactions with affiliates?
- How are we managing to restrictions on senior securities/unfunded commitments?

Tax

- Are we properly addressing the asset diversification requirements?
- Are we meeting the qualifying income test?
- Do we maintain sufficient cash flow to meet the distribution requirements?
- Do we know how exiting a controlled subsidiary might impact RIC qualification?

Valuation

- Have we determined and implemented leading practices in BDC valuation?
- What controls and costs are in place around valuation?
- Is the board sufficiently educated in valuation procedures?

Source: Deloitte Center for Financial Services analysis.

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Endnotes

- ¹ Defined by Thomson Reuters Markets as syndicated- or club-loan deals, \$500 million and below in total deal size, for issuers with revenues of \$500 million and below.
- ² Small Business Investment Incentive Act of 1980, H.R. 7554, 96th Cong. (1980).
- ³ US Securities and Exchange Commission, "Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Amendments to Rule 2a-46," May 15, 2008.
- ⁴ CEFA's Closed-End Fund Universe, December 31, 2014.
- ⁵ Data sourced from S&P Capital IQ, December, 2014; Thomson Reuters Markets, September, 2014.
- ⁶ CEFA's Closed-End Fund Universe, December 31, 2014.
- ⁷ US Securities and Exchange Commission, "Business Development Company Report," November 2014.
- ⁸ Leveraged Commentary & Data (LCD), S&P Capital IQ, December, 2014.
- ⁹ Wilshire Business Development Index, December 2014.
- ¹⁰ CEFA's Closed-End Fund Universe, December 31, 2014.
- ¹¹ Shayndi Raice, "Smaller Banks' Loans Growing Faster Than Larger Rivals," *Wall Street Journal*, September 4, 2013.
- ¹² Thomson Reuters Markets, September 2014.
- ¹³ US Securities and Exchange Commission, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds," RIN: 3235-AL07, December 10, 2013.
- ¹⁴ US Securities and Exchange Commission, Investment Management Guidance Updates: "Business Development Companies with Wholly-Owned SBIC Subsidiaries—Asset Coverage Requirements," June 2014; "Investment Company Consolidation," October 2014; "Business Development Companies—Transactions with Certain Second-tier Affiliates," December 2014.
- ¹⁵ CEFA's Closed-End Fund Universe, December 31, 2014.
- ¹⁶ Fitch Ratings, "Removal of BDCs from Indices May Reduce Equity Access," March 13, 2014.
- ¹⁷ Fitch Ratings, "BDCs' Off Balance Sheet Loan Programs Distort Leverage," September 22, 2014.
- ¹⁸ Thomson Reuters Markets, September, 2014.

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