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Credit the yield

Of the 43 component companies in the Standard & Poor's index of business-development company shares, only three reported a sequential gain in fourth-quarter book value. Of the remainder, 39 disclosed a decline (the 40th is incommunicado; radio silence since July). Reflecting a 5.6% average loss in book value between Sept. 30 and New Year's Eve, the 43 names trade at an average 11% discount to net asset value.

Now under way is a reprise and a report: a reprise of a couple of familiar yield-bearing *Grant's* favorites (see the issue dated Oct. 16) and an informal survey on the state of small-business credit. We remain bullish on Solar Capital Ltd. (SLRC on the Nasdaq), which changes hands at a 16% discount to book value, and friendly, in a platonic way, to Golub Capital BDC, Inc. (GBDC on the Nasdaq), the gold standard in the BDC sector, which trades at a 10% premium to book value. Solar is priced to yield 9.1%; Golub, 7.3%.

As you'll recall, BDCs are lightly leveraged closed-end funds that originate and hold investments in businesses that the public markets won't deal with and the heavily regulated post-crisis banking system is encouraged to shy away from. At the highest reaches of middle-market credit quality, you wouldn't suppose that the American economy were stumping along at a rate of GDP growth only slightly in excess of stall speed. Yet there are signs, even here, of some cyclical fraying.

For proof, consider the 150 or so companies in the Golub Capital portfolio. In the first quarter, they showed a 9.1% year-over-year rise in revenue and a 5.1% year-over-year rise in EBITDA, i.e., earnings before interest, taxes, depreciation and amortization. Each rate of gain was well above its fourth-quarter reading of 6.7% and 2.2%, respectively. Observe, however, comments David Golub, the CEO and eponym of Golub Capital, that profit growth was slower than revenue growth. In the wake of the Great Recession, the bottom line outgrew the top line.

"While revenue growth in our portfolio rebounded in Q1, a theme we hear over and over is that margins are under pressure," Golub tells colleague Evan Lorenz. "They are under pressure for two reasons. One is wage pressure. The second is currency-related—either lower profits from abroad due to currency translation or increased competition from foreign suppliers who are getting the benefit from the strong dollar."

The state of the nation's business, as evidenced by his portfolio companies, is no better than "trudging," Golub relates. One might say, he adds—the people at Golub Capital *are* saying—that a kind of "profit recession" has begun.

Not that even an earnings slump in their portfolio companies would account for the widespread drop in the NAVs of the business-development companies themselves. What goes far to explaining it is illiquidity, the kind that comes with the middle-market territory. BDCs carry their loans at the price that those credits might realize in an arm's-length transaction. "Might" is key, as few such loans trade. As a first approximation to a market-determined value, BDC managers mark their portfolios to the prices they observe in the markets in which securities do trade. Thus, when the prices of leveraged loans and junk bonds come under pressure, so do the estimated values of the loans on the BDC balance sheets.

Solar Capital recorded a 3.4% drop in fourth-quarter book value that stemmed from this very kind of fair-value adjustment. Even Golub bore a mark-to-market decline, though gains on equity investments offset it. The net of these marks delivered a gain of ½ of 1% in Golub's fourth-quarter NAV, the mightiest advance in the S&P BDC Index.

More worrisome is the kind of loss that reflects actual credit impairment. Attempting to boost yield by reaching for it, a number of BDC managers have purchased equity interests in collateralized loan obligations or plunged into energy lending. PennantPark Investment Corp. (PNNT on the Nasdaq) is the poster child of concentrated oil-and-gas exposure: With 10% of its portfolio at fair value at risk in energy-related companies, PNNT suffered an 8.1% drop in fourth-quarter NAV; by way of reparation, management is waiving 16% of its fees through Dec. 31.

Neither Golub nor Solar has disclosed any energy exposure or so much as a dollar of CLO investment. Lorenz asked Golub whether the level of book-value erosion among his BDC brethren surprises him. "I expected market-value declines in Q4 because spreads widened," Golub replied. "What surprised me in Q4 was the number of credits (not so much in our portfolio but in the market) that started to show some really meaningful credit-related difficulties, not market-value adjustments but real, legitimate credit stress."

The difficulties, though concentrated in energy, were not confined to oil and gas. "Everyone tends to forget that the everyone-is-a-genius part of the credit cycle does not last forever," Golub went on. "For this cycle, it appears the everyone-is-a-genius part of the credit cycle ended in the fourth quarter of 2015."

With respect to the Fifth Street collegium of companies, the genius phase can be said to have ended even earlier. Fifth Street Finance Corp. (FSC) and Fifth Street Floating Rate Corp. (FSFR) are a pair of BDCs managed by Fifth Street Asset Management, Inc. (FSAM); each is listed on the Nasdaq. Constant readers will recall the alacrity with which FSC and FSFR slashed dividends after raising additional equity capital a year and a half ago (*Grant's*, Oct. 3, 2014). In the case of Fifth Street Floating, the Aug. 14, 2014 offering was at a heavy discount to book and, for that reason, highly dilutive; it expanded the share count by 242%.

Where's Carl Icahn when you need him? Nowhere near Fifth Street. It was rather RiverNorth Capital Management—owner of 6% of FSC shares—that called out FSAM over its evident mismanagement of FSC and FSFR. To set things right, RiverNorth vowed to run its own slate of directors in a proxy contest as well as to hold a vote to terminate FSAM's management contract with FSC. This was on Nov. 16, and a happy day it was. Who could doubt the merit, even the virtue, of the activist's case? Since a June 12, 2008 IPO at $14.12 a share, FSC had suffered a 36% plunge in book value per share.

Peace broke out on Feb. 19 when RiverNorth withdrew its contested proxy and agreed to support the incumbent directors. It came to light that FSAM and Leonard M. Tannenbaum, the chairman and CEO of FSAM, had agreed to purchase RiverNorth's stake in FSC at a premium and issue RiverNorth a warrant on FSAM. On the news, FSC dipped by 5% and FSAM soared by 103%.

Here was a remarkable about-face. Would RiverNorth care to explain it to *Grant's*? Could it help us to understand its newfound affinity for the management team at which it had previously tossed tomatoes? RiverNorth, responding to neither emails nor telephone calls, would not.

Widening credit spreads are proving a double-edged sword for the BDCs. On the one edge, they've prompted the aforementioned mark-to-market reduction in the carried value of BDC assets. On the other edge, they've sharpened the pricing of new credits. "Pricing, depending on whether you are first lien, second lien, unitranche [i.e., loans that combine both senior and mezzanine loans], has widened out from 50 to 150 basis points," Bruce Spohler, chief operating officer of Solar Capital, tells Lorenz.

Solar makes a specialty of lending in the life-sciences field (it also makes asset-based loans and senior-secured and first-lien loans). The firm likens its lending to biotech and pharma companies as late-stage venture finance. "We are cheaper at 16% to 17% interest rates than raising another round of equity," Spohler says. "It's about being late-stage where you have enough value in the intellectual property that someone will buy off your loan at par to make sure they can take it over."

Solar has distinguished itself, first, by withholding commitments to markets that it judged to be rich, and, second, by springing into markets that it judges to be value-laden. The fourth quarter was the time it sprung. At the year-end accounting, Solar's investment portfolio was 47% larger than it had been 12 months earlier. And as its assets expanded, its leverage ratio rose, to 0.49:1 from 0.24:1. Management adds that, as it targets a regulatory leverage ratio of 0.65:1 to 0.75:1, there's room for further growth, if values allow it.

"What the market doesn't understand or give us full credit for is we are one—if not the only—BDC that will have increased earnings this year as we go towards our target debt to equity," says Michael Gross, the CEO. "We will see our earnings grow from 40c a quarter to the mid-40s as the year progresses. That will allow us to have a conversation about actually increasing our dividend vs. other BDCs' decreasing dividends. If people really understood that, we wouldn't be trading where we are today."

Like Golub, Solar works to position itself as a senior claimant. As of Dec. 31, senior secured loans filled almost 93% of the Solar portfolio, with unsecured debt (4.5%) and equity (2.6%) accounting for the balance. Non-accrual loans weighed in at 0.2% of loans at fair value.

"While a rapidly growing portfolio can, for a time, understate rates of credit decay—after all, it typically takes some time before borrowers stop paying—to Solar's credit the company withheld capital from the frothier markets in 2013, 2014 and the first half of 2015," Lorenz observes. "Since November, the Solar insiders (including the management company) have bought 147,279 shares of SLRC for a grand total of $2.5 million."

If Solar is up and coming, Golub has already arrived. The latter seeks out, and seems to find, what J.P. Morgan (the man) described as "first-class business in a first-class way." Problem loans are de minimis, credit quality has proven exemplary and management treats the stockholders as if it were an owner, too (insiders do, in fact, own 4.4% of the GBDC). As of Dec. 31, the portfolio was 99% invested in senior claims of one kind or another, with the residual in equity. Non-accruals, as of Dec. 31, totaled 0.5% of the portfolio at fair value, up from 0.4% and 0.2% in the quarters ending Sept. 30, 2015 and Dec. 31, 2014. Golub uses $1 of debt for $1 of equity.

The Golub insiders have lately bought no stock, not even at the February lows, when the share price briefly dipped below book value per share. At a 10% premium to NAV, we would call GBDC just now an investment to admire rather than to initiate.

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