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Yield on sale

Interest rate risk and credit risk compete for pride of place on the worry list of thoughtful income-seekers. Where to turn for a fighting chance to earn 8% or 9% per annum? Business development companies, familiarly known as BDCs, are the subject at hand. To jump the analytical gun, we're bullish on two and bearish on two.

BDCs are non-bank lenders. They are lightly leveraged, as the 1940 Investment Company Act requires them to be. The pair on which we're keen has a demonstrated proficiency in lending to small and medium-sized business. Income is what many need nowadays. Here is a way to procure it with moderate risk.

Ares Capital Corp. (ARCC on the Nasdaq) and Golub Capital BDC Inc. (GBDC on Nasdaq) are our two featured exhibits. Ares, which went public 10 years ago, sailed through the financial crisis with loan losses that put America's big banks to shame. The share price, we hasten to add, didn't sail but sank before recovering; in the heat of crisis, not many paused to distinguish between babies and bath water (*Grant's*, Oct. 19, 2013). Golub, which began its career as a public company only in 2010, likewise posted strong credit results in 2007-09 while operating as a private company (*Grant's*, Nov. 2, 2012). The BDCs have stumped along well enough in this time of suppressed interest rates. They would likely prosper in a time of rising interest rates.

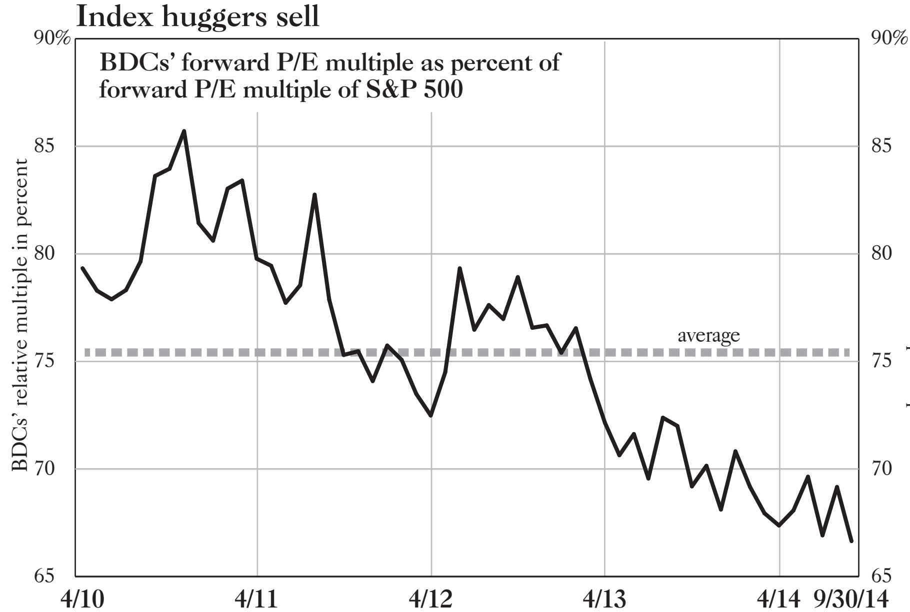
What makes BDCs newly topical is their valuation. Compared to a 7% rise in the S&P 500 this year, Ares and Golub have notched share-price declines of 9% and 17%, respectively. Yield compression—the great scavenger hunt for income—is one reason for this underperformance. The anomalies of index investing is a second.

Some months back, the keepers of the S&P 500 and of the Russell indices gave the BDCs the boot. Inasmuch as passive index funds owned 10% of the industry's public float, the BDC shareholder base was literally decimated.

The index-keepers had no substantive gripe against the likes of Ares and Golub. The issue rather centered on the optics of financial reporting. The index-fund purveyors chafed at having to record the BDCs' management expenses as their own (as the SEC required under the so-called acquired fund-fee expense rules). "So, for example," Greg Mason, managing director of specialty finance at Keefe, Bruyette & Woods, advises colleague Evan Lorenz, "if Vanguard charges a 15 basis-point fee and they invest 1% of the index funds in BDCs, which have all-in costs of 4% of assets, Vanguard would have to add four basis points to its fund expenses. It would, therefore, have to report a management fee of 19 basis points. While four basis points seems like a tiny amount, it's a huge increase on a percentage basis."

Thanks in part to this technical dislocation, Ares now trades at a 2% discount to book vs. a 8% premium at the end of 2013; Golub trades at a 3% premium vs. a 25% premium (see the afore-cited *Grant's* of Dec. 13 for a lamentation on the higher

Index huggers sell



source: Keefe, Bruyette & Woods

valuations that were in force late last year). Ares and Golub are priced for dividend yields of 9.4% and 8%, respectively. In fact, BDCs in general look cheap. "Historically, the BDCs have traded around 76% of the forward P/E multiple of the S&P 500," Mason relates. "If you do the same math for the banks, the bank industry has also traded at about a 75-80% P/E of the S&P 500. Today, the BDCs are at 67%. We are trading almost a 10% discount on a relative P/E basis to the S&P 500."

Technical reasons alone, as mentioned, do not explain all the share-price weakness. The same yield famine that drove the junk-bond market to crazy heights has also distorted the pricing in middle-market lending. "Middle-market debt as an asset class is clearly not as attractive today as it was three years ago," says David B. Golub, eponym and CEO of Golub Capital. "In middle-market lending, we are insulated from but not immune to changes in liquid credit markets. In the last several years, terms in middle-market lending have gotten more favorable for borrowers. We've seen that in the form of some decrease in spreads and some increase in typical leverage levels."

The cyclical pendulum is starting to favor the lenders again. Certainly, they're getting back some of their own in the public markets. Junk-bond yields made their lows in the third week of June with a 5.16% reading on the BofA Merrill Lynch U.S. High Yield Index. At last report, the index had shot back up to 6.55%. After reaching a high of $175.1 billion at the end of March, funds invested in retail bank-loan funds had declined to $163.7 billion in August (September data are due in mid-October). Ares and Golub each tell Lorenz that the selling squalls in public markets have led to stabilization in the yields in the private, non-traded market for small-business debt.

Still, a "stabilized" yield in the year 2014 is anything but a generous one. The typical BDC is borrowing at 5% and lending at 9%, a spread that affords little margin for underwriting error. How does Ares, for instance, protect against credit losses that could take a debilitating bite out of its top and bottom lines? Lending more in a senior capacity, less in a junior one, says Kipp deVeer, newly appointed CEO (he was previously president of the firm and has worked at Ares since its inception; Michael J. Arougheti, the former CEO, remains on the board as co-chairman).

"We've been in this part of the cycle before," deVeer tells Lorenz. "It's a recognition of the experience of the team here that providing credit is an inherently cyclical business. Unfortunately, most people get it wrong—they see the market environment that we are in today with strong deal flow, pretty good fundamental performance, and limited to no defaults in portfolio companies, and they say, 'This is a good time to be pumping capital out. There doesn't seem to be any risk.'

"Since we tend to hold everything we invest in for three to five years, we look to invest in cycle durable assets," deVeer goes on. "We are also an opportunistic, relative value investor throughout business cycles. So it's not about what the environment is like today or what it has been like for the last few years, which has been pretty good and has been an easy time to invest money. It's about what it will be like over the next five years."

As of June 30, Ares managed an $8.6 billion portfolio, of which 44% was apportioned to first-lien, senior secured loans, 16% to second-lien senior secured loans, 5% to senior subordinated debt, 3% to preferred equity and 8% to common equity. The remaining 24% of assets was deployed through a joint venture with GE Capital Corp. and GE Global Sponsor Finance LLC; the j.v. is called the Senior Secured Loan Program. While the SSLP makes senior secured loans, Ares is the junior claimant; to that degree, therefore, the SSLP's assets, from the Ares perspective, are subordinated (which subordination lends an extra fillip of leverage to Ares' balance sheet).

Including the SSLP, the interest rate attached to 81% of Ares' loans is floating. At the end of the second quarter, nonperformers amounted to 1.2% of Ares' assets (which matches the lows of 2007). Debt less cash amounts to 64% of stockholders' equity.

Golub Capital takes what it calls a "one-stop," or "unitranche" approach to lending. Its preferred position in the capital structure of its investees is that of the one and only creditor. In effect, it holds both the senior *and* the subordinated claim, all in the same loan.

"Junior debt providers get paid two premiums: the first is for taking junior credit risk, for being junior in the capital structure," Golub tells Lorenz. "The second premium they get paid is for taking the risk that there will be some conflict between senior creditors and junior creditors; the senior creditors may take some action that is good for the senior creditors but bad for the junior creditors. In a 'one-stop' we get paid for that second risk—but we are not taking it. Because we are both the senior and the junior debt, we are able to work with the company and the sponsor to come up with a plan from a remediation standpoint that is good for both positions, not one position over the other. To date, our default rate on one-stops has actually been lower than our default rate on traditional senior loans."

A fraction of Ares' size, Golub Capital, as of June 30, managed $1.5 billion, of which 65% was committed to one-stop loans, 22% to senior secured loans, 6% to second-lien loans, 3% to equity, and 1% in subordinated debt. Another 3% was consigned to a joint venture with the RGA Reinsurance Co. Fully 96% of Golub's portfolio was in floating-rate claims. Nonperformers amounted to a mere 0.02% of quarter-end assets.

Lorenz asked Golub if this essentially flawless credit record betrayed an unprofitable excess of caution. Could it be that Golub Capital is taking too little credit risk for the stockholders' own good? "Excellent question," Golub replied. "Arguably, it means we have been too cautious, but such judgments require more time to steep. Clearly it reflects strength in the portfolio. We are pleased with the positioning of the portfolio." As to June 30 balance-sheet leverage, Golub Capital borrowed 83 cents, net of cash, for every dollar of equity.

"Ultra-easy money isn't all bad for the BDCs," Lorenz points out. "Yields are shrunken on both sides of the balance sheet. Both Ares and Golub have seized the opportunity to extend—to 'term out'—the duration of their borrowings. Thus, Ares has no debt maturities until 2016; Golub's first maturity is in 2018. 'Over the past several years, we have extended the duration of our liabilities, which average about seven to eight years vs. a three- to four-year duration on our assets,' deVeer says. 'What really created a lot of market issues in the last downturn was forced selling by participants due to liability mismanagement. We have put ourselves in a better financial position, as have many others, which we believe could lead to more stability.'"

Good businesses in their own right, Ares and Golub shine the brighter in comparison with a pair of BDCs under the stewardship of Fifth Street Asset Management. Fifth Street Finance Corp. (FSC on the Nasdaq) is the first of these uncomely siblings; Fifth Street Senior Floating Rate Corp. (FSFR, also on Nasdaq) is the second.

The Fifth Street entities, like Ares and Golub, are governed by a legally distinct external manager. It's an arrangement that presents a weak-willed overseer with the temptation to subordinate the stockholders' interests to his own. "I've often said this in the context of our new equity issuances that they have to be good for new investors, old investors and the manager or we shouldn't do them," remarked David Golub on his Aug. 7 earnings call.

By the Golub score-keeping method, Fifth Street management not infrequently bats one-for-three. In September last year, as you may recall (*Grant's*, Dec. 13), Fifth Street Finance issued 17.64 million new shares at $10.31. The market seemed to interpret the sale as a vote of confidence; would a conscientious management raise equity with 11 days left in the quarter if there were anything in the offing except good news? The market misjudged its man. On Nov. 25, Leonard M. Tannenbaum, CEO of Fifth Street Finance, announced a dividend cut. Today, FSC trades at $9.18 per share, a 5% discount to book.

Organized as regulated investment companies, BDCs must pay out in dividends at least 90% of their earnings. Retaining so little income, they tend not to generate significant growth in book value. The shareholders get the profits—and pay taxes on them.

Which is not to say, though, that good BDCs generate no growth—or that the bad ones don't generate losses. Accomplished managements boost net worth in two ways. They avoid credit mistakes. And, they harvest such equity co-investments or warrants as they might have seeded along the way. Thus, over the course of its 10 years as a public BDC, Ares has managed to boost its book value per share to $16.52 from $13.85. Over the four years ended June 30, Golub managed to raise its book value per share to $15.44 from $14.67. As for Fifth Street Finance, from its debut as a public company in the first quarter of 2008 through the June quarter of 2014, Tannenbaum managed to shrink its book value per share to $9.71 from $14.12.

The other Fifth Street fund, Fifth Street Senior Floating Rate Corp., has proved not much more rewarding to the outside investors. FSFR came public on July 11, 2013. The IPO fell flat: just 6.67 million shares were taken up at a price of $15 per share. So small were the proceeds—just $100 million—that Fifth Street Asset Management, the external manager, announced that it would cover the $5.7 million in underwriting expenses. FSFR's opening-day pop was to the down side, and on no subsequent day has the share price topped book value per share.

Fast forward one year. Would the stockholders Tannenbaum petitioned in the 2014 proxy permit the sale of stock at a discount to book value? By early July, the votes were in. Incredibly, the owners voted "aye"; book value was now $15.13 a share.

Fifth Street wasted no time with the equity drop. On Aug. 14, it sold 22.8 million shares at a price of $12.91. Which is to say, it expanded the share count by 242% through raising equity at a 14.7% discount to stated NAV. This time, Fifth Street Asset Management did not swallow the underwriting fees; the $17.7 million in charges resulted in net proceeds per share of $12.14 for FSFR. Today, the stock trades at $11.82 a share.

Why the stockholders—management only holds a 2.3% stake in FSFR—voted as they did is a mystery. Why Tannenbaum would have chosen to finance on these disadvantageous terms is slightly less mysterious. Fifth Street Asset Management is in the process of going public through the auspices of Goldman Sachs and Credit Suisse, among others. According to the S-1 offering circular, the two Fifth Street siblings, FSC and FSFR, constitute 99% of Fifth Street Asset Management's assets under management. While FSFR's secondary offering was of no obvious benefit for existing shareholders and a dubious benefit to new shareholders (while they buy in below book value, they are investing in a management team that is willing to dilute investors and has destroyed book value through poor underwriting in Fifth Street Finance Corp.), it does stand to increase the fee-paying assets for Fifth Street Asset Management just in time for the impending IPO.

Too bad Fifth Street isn't in the baseball business. In baseball, going one-for-three is performance that puts you on the road to Cooperstown.

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