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Search for survivors

The fat lady keeps her counsel, but it's not too soon to speculate on the close of this prodigious cycle of lending and borrowing. Now in progress is a survey of the pitfalls and opportunities in one problematic corner of credit.

Middle-market lending in general, and business-development companies in particular, occupy that worrisome niche. In preview, we document the spread of sloppy underwriting practices while reaffirming our bullishness on Solar Capital Ltd. (SLRC on the Nasdaq; see the issue of *Grant's* dated Oct. 20, 2017). We are friendly, too, towards an assortment of BDC baby bonds. Concerns, yields and analysis to follow.

Low interest rates, with lending standards to match, have facilitated a wave of borrowing by medium-size businesses in the past two years. "Middle-market" credit nowadays connotes the kind that finances leveraged buyouts, lines the pockets of the private-equity promoters and facilitates potentially defensible acquisitions. You'd expect as much in the wake of a decade of monetary electric-shock therapy.

The competition to press money on illiquid, leveraged borrowers has ensnared neither all private middle-market lenders nor each of the BDCs (we single out some of the prudent ones below). Still, for any who compete to lend, it's hard to remain aloof from the creditors' melee. Ares Management, L.P. described the lending opportunity as it used to exist in an April white paper titled "Opportunities in Global Direct Lending: A Historical and Prospective View of the U.S. and European Markets":

> Investors find middle-market direct loans attractive due to their floating-rate nature, high current yields and lack of correlation to traded assets. In fact, middle-market senior loans have generated superior returns compared to liquid leveraged loans (spread premiums of 245–325 basis points) and generated comparable returns to high-yield bonds, but with security and less volatility. In addition, U.S. middle-market loans have generated a higher Sharpe Ratio vs. the S&P/Loan Syndications and Trading Association U.S. Leveraged Loan 100 Index, High Yield Bond Index and the S&P 500 over a three-, five- and seven-year period. . . .
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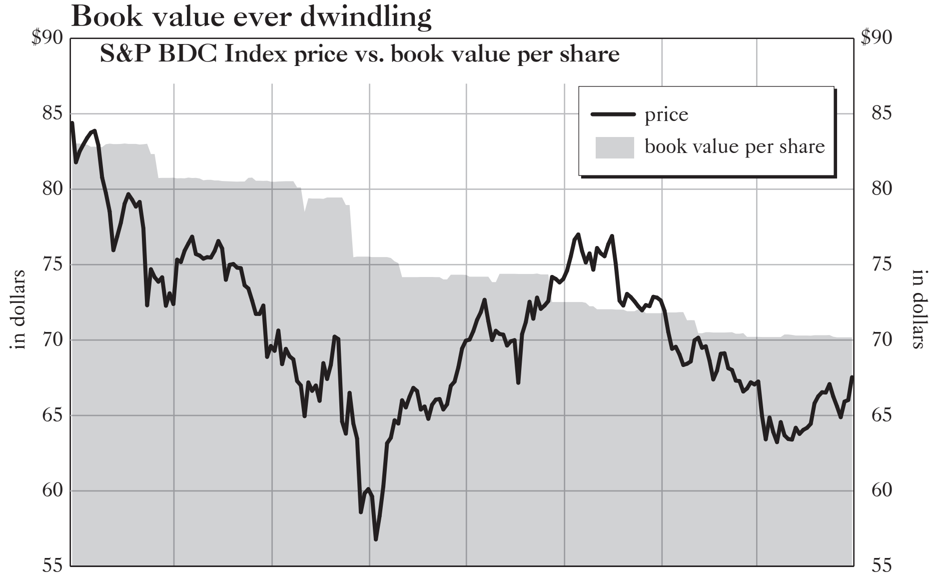
> Middle-market loans generally include stronger covenant packages, more frequent and transparent financial reporting, and often have higher amortization payments. We believe these protections have contributed to capital preservation and lower default rates.

Perhaps the problem lies in the familiarity of that happy history. Knowing it, you're almost prepared to believe that, yes, past performance *is too* the guarantee of future results. It would be strange if it were in this instance, given weakening capital structures, the breakdown in the protection afforded by the legal covenants and the debasement of such expandable concepts as "adjusted EBITDA (earnings before interest, taxes, depreciation and amortization)."

"Market terms continue to be challenging with many aggressive participants willing to provide high leverage to

Book value ever dwindling



source: The Bloomberg

companies along with looser documentation and structures," Kipp DeVeer, CEO of Ares Capital Corp. (ARCC on the Nasdaq), advised dialers-in on the May 2 earnings call.

"The biggest difference is that larger middle-market companies in excess of $40 million or $50 million of EBITDA are very often able to achieve cov-lite executions in the syndicated market," said David B. Golub, CEO and eponym of Golub Capital BDC, Inc. (GBDC on the Nasdaq), on his May 8 earnings call.

The 44 component companies of the S&P BDC Index show assets of $62.7 billion. It's a pittance compared with the $909 billion in middle-market loans that, by Ares's estimates, were outstanding at year-end. It sounds like a lot of money. Is it? It would certainly prove to be if the borrowers staggered under its weight. Ryan Lynch, analyst at Keefe, Bruyette & Woods, Inc., tells colleague Evan Lorenz that, in the second quarter, the average middle-market borrower showed a ratio of debt to EBITDA of 6:1. In the same quarter two years earlier, 5:1 was par for the course.

"They continue to push the envelope," Bruce Spohler, chief operating officer of Solar Capital, tells Lorenz of his aggressive competition. "It goes beyond the absence of maintenance ratios. It goes to sacred rights about covenants that preserve your first lien. We see new creative thinking all the time about how to loosen the terms."

Is this, then, the ideal time to ramp up BDC leverage? Many will doubt it, but President Trump, on March 23, signed a law to allow it. Prior to the enactment of the Small Business Credit Availability Act of 2018, BDCs could borrow no more than one times their equity. Now they can borrow twice as much.

Not that they must or necessarily will. As it is, the BDCs average 71 cents of debt for every dollar of equity. Apollo Investment Corp. (AINV on the Nasdaq), which had been employing only 57 cents, says it will proceed to borrow as much as $1.25 to $1.40. Ares says it expects to target a 0.9-to-1.25-times leverage ratio from the 0.69:1 reading it posted in the first quarter. Golub, which at last report used 87 cents of debt per dollar of equity, seems inclined to stand pat.

ARCC and AINV each debuted in the public market in 2004, but that similarity is one of the few they share. Over the ensuing 14 years—a span which of course includes the 2008 Global Bump in the Road—Ares has managed to suffer no loss in book value per share. It may seem like faint praise, but BDCs, like REITs, must pay out at least 90% of their income. You can't protect your equity if you're losing money on your underwriting.

Nor has Apollo managed that feat. Its book value per share slumped to $6.56 from $14.05 over the same interval. In stoking up leverage now, the Apollo front office promises to invest in only "lower-risk" assets. If so, management will have some adjustments to make. As of March 31, such senior claims filled only half of the Apollo portfolio.

"Apollo's poor performance is, sadly, more the rule than the exception," Lorenz reports. "Book value per share of the S&P BDC Index declined to $70.47 in the first quarter from $81.45 at year-end 2014, and the indexed BDC share price slumped right along with it, to $67.46 today from a high of $88.37 in 2014. Underachievement is the rule, not the exception. Jonathan Bock, analyst at Wells Fargo Securities, LLC, finds that 28 of the 36 BDCs he tracks have generated net loan losses since their respective start dates. In those 28 cases, of course, book value per share has likewise dwindled."

Golub deserves special mention on several counts. First, book value per share has crept higher since the BDC went public in 2010. From which it follows, second, that credit experience has been exemplary. Of the five private Golub credit partnerships that preceded the Golub BDC, four generated a positive return in 2008. The exception bounced back in 2009 with a 22.5% gain. As for the Golub BDC, at the end of the second quarter it showed nonaccruing loans equivalent to 0.1% of assets. And there is a third point of excellence. In response to simple questions, Golub management habitually gives clear, direct, unspun answers.

Thus, David Golub told dialers-in on the first-quarter earnings call, "If you look at what we're constrained by today, we're not constrained by an insufficient ability to use leverage. We're constrained by an absence of . . . many attractive new investment opportunities. . . . We could grow now by having GBDC issue new shares at a premium to NAV and borrowing at 1-to-1 if we wish to. We're choosing not to. And we're choosing not to because we think this is the kind of environment in which it pays to be cautious."

Of course, these virtues are nobody's secret. GBDC changes hands at a 16% premium to book value while delivering a 6.8% dividend yield. Ares, which likewise boasts a distinguished long-term record but which shows a greater tolerance than Golub for junior credits, trades at 100% of book and pays a 9% dividend. We judge that Mr. Market is on the beam with each valuation.

Perhaps, though, in Solar Capital, the old gentleman is low-balling it. While some 40% of Solar's book of business is susceptible to the kind of ferocious competition that afflicts even Golub and Ares, the remaining 60% is somewhat protected—and it's growing. These specialty lines of underwriting include asset-based lending (29.2% of the portfolio), lending against capital equipment (17.9%) and lending to the life-sciences industry (13.2%).

As of March 31, Solar's $1.8 billion portfolio was invested in first-lien loans (78.9% of the total), second-lien loans (19.3%) and equity and equity-like secu-

BDC baby bonds

	maturity	coupon	price	yield to next call	next call
Harvest Capital Credit Corp.	9/15/22	6 1/8	$25.58	4.65%	9/15/19
TriplePoint Venture Growth BDC Corp.	7/15/22	5 3/4	25.20	5.07	7/15/19
Saratoga Investment Corp.	12/30/23	6 3/4	25.81	4.16	12/21/19
MVC Capital, Inc.	11/30/22	6 1/4	25.51	4.79	11/30/19
Horizon Technology Finance Corp.	9/15/22	6 1/4	25.48	4.97	9/15/19
Triangle Capital Corp.	12/15/22	6 3/8	25.19	4.35	8/20/18
Oxford Square Capital Corp.	3/30/24	6 1/2	25.61	5.09	3/30/20
Hercules Capital, Inc.	4/30/25	5 1/4	25.82	5.38	4/30/21
Capital Southwest Corp.	12/15/22	6	25.30	5.34	12/15/19
Triangle Capital Corp.	3/15/22	6 3/8	25.16	5.35	8/20/18
Stellus Capital Investment Corp.	9/15/22	5 3/4	25.17	5.65	9/15/19
OFS Capital Corp.	4/30/25	6 3/8	24.80	6.82	4/30/20

sources: The Bloomberg; Keefe, Bruyette & Woods, Inc.

rities (1.8%). And as of the latest quarter, precisely zero percent of Solar's loans was non-performing.

Asset-based lending, the biggest of Solar's niche businesses, means lending against the liquidation value of collateral. The borrowers who consent to Solar's terms likely have more assets than cash flow—retailers, for instance. "The sector that has been most active has been retail just given the secular headwinds they are facing from online retailers," Spohler tells Lorenz. "They have liquid collateral in terms of finished-goods inventory which really play to the strength of our ABL team."

Adds Solar CEO Michael Gross: "When you think about that business, it is somewhat countercyclical to the [traditional mid-market] business. When we do run into a more difficult economy/financing environment, the need for that kind of capital goes up dramatically. We could easily see the portfolio double in size in a more difficult environment."

The second-largest specialty line is in capital equipment. This involves lending against 60% to 65% of the liquidation value of trucks, school buses, computer-numeric-control cutting machines, tug boats, armored security trucks, mining equipment and what have you. "It is the most fragmented market of any of the businesses we are in," Gross says. "There is no one, two or three people who are driving pricing. There is no real capital formation in this space. It is the same people who've been doing this forever. There is real discipline because you are financing pieces of equipment/hard assets."

The life-sciences operation, the third of Solar's non-generic credit businesses, is its smallest and most exotic. There are not many competitors. The target borrower is a late-stage, venture-capital-funded biotech company that finds a 10% or 12% loan more attractive than diluting equity holders before an eventual IPO or sale to a larger pharmaceutical company. "Our team did this for 14 years in [General Electric Co.]," Spohler says. "They have a phenomenally consistent track record of no losses and very high returns, similar to what they are doing since they joined Solar: 17–18% type returns with no losses."

In 2013, loans totaling a third of Solar's portfolio refinanced, presenting management with a choice. Quickly replace the credits, perhaps sacrificing credit quality, or cut the dividend. The credit-minded Solarians did the right thing and sacrificed the dividend.

With this in mind, we doubt that management will be rushing out to avail itself of the government-given opportunity to turn up its leverage from its long-time average of 23 cents to the equity dollar. Gross told his audience on the May 8 earnings call that his colleagues and he are taking the leverage question under advisement. "We'll be extremely deliberate in our analysis and have not yet reached a conclusion regarding our course of action," he said. "For Solar, our analysis centers on balance-sheet optimization, portfolio and financing flexibility and risk management and not on maximizing leverage. Because of our strategic focus on acquiring, building and growing specialty finance businesses, the considerations for our platform are somewhat unique. Importantly, we feel no pressure at all to make changes to our investment strategy in order to 'make the dividend math work.'"

The shares trade at 95% of book and pay a 7.9% dividend yield.

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"Baby bonds" provide another BDC income play. They're little bonds—$25 par value—and they're intended for retail investors. Within a BDC capital structure, they're typically ranked senior unsecured. They're callable (at least every issue in the accompanying table is callable), and because most trade above par, the yield-to-next call is the metric on which an investor ought to focus. The opportunity is the paper which, if called in the next year or two, will deliver a yield of around 4.5%. If not called, it will return something on the order of 6% at maturity.

"We are not aware of any lenders ever losing any principal or interest lending to a BDC," Lynch wrote in a June 27 report to the clients of Keefe, Bruyette & Woods. "This is due to the low regulatory leverage. . . . The average historical cumulative loss rate is less than 5% for those BDCs with a baby bond outstanding."

With the aforementioned average leverage ratio of 0.7 times debt to equity, the typical BDC would have to incur losses of 59% before debt holders suffered losses. Even if a BDC elected to take every last fathom of rope that the president has offered to it, thus increasing its leverage to 2:1, losses would have to rise to 33% before bondholders bore a loss.

"BDC baby bonds compare favorably with other junior credit investments featured in these pages," Lorenz winds up. "For instance, the mouthful of an investment designated 'AGNC Investment Corp. 7% Series C fixed-to-floating rate cumulative redeemable preferred shares' is priced at $25.67 to yield 6.25% to call. Annaly Capital Management, Inc.'s 6.95% Series F fixed-to-floating rate cumulative redeemable preferred shares are priced at $25.47 to yield 6.54% to call. AGNC and Annaly have lower equity cushions than the BDCs; they leverage their portfolios (or did on March 31) by 8.2 times and 6.5 times equity, respectively. Stricken from our list are Capstead's 7½% Series E cumulative redeemable preferred shares—we designated them picks-to-click in our Oct. 6, 2017 issue. Priced at $25.27, the Series E became callable after May and therefore have a yield-to-next call of negative 8.27%."

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