GRANT'S
INTEREST RATE OBSERVER®

Vol. 33, No. 20e · Two Wall Street, New York, New York 10005 • www.grantspub.com · OCTOBER 16, 2015

Constructive developments

"This earnings season—and I expect prospectively—we will start to see greater dispersion of credit results," David B. Golub, CEO and eponym of Golub Capital BDC, tells *Grant's*. "We are coming out of the everyone-is-a-genius part of the credit cycle. From here, we are going to see both more mark-to-market losses and more permanent impairments—especially in those places where loan managers have in recent years been taking more risk, such as energy lending, junior debt and CLO equity. I anticipate we'll see outcomes in the sector ranging from very good to not-so-good."

Business-development companies—BDCs, to their friends—are the subject of this unfolding analysis. We are bullish on Solar Capital Ltd. (SLRC), a newcomer to these pages. We are admiring of Golub (GBDC), the industry's fully-priced gold standard, and watchful-and-waiting toward Ares Capital Corp. (ARCC), which is, as the psychologists say, experiencing a life transition. All three trade on the Nasdaq.

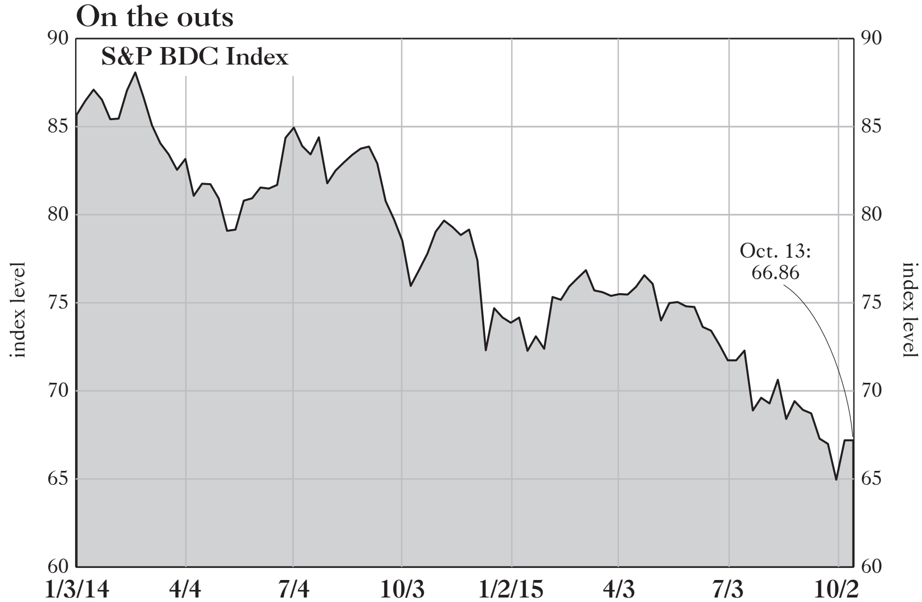
Lightly leveraged closed-end funds, BDCs originate and invest in loans to companies that are generally too small to tap the public markets. It can't be said that the world is in thrall to this branch of the American debt-production industry—nor, in view of deteriorating credit conditions, should it necessarily be. Since Sept. 1, 2014, the S&P BDC Index has declined by 20% in price and by almost as much by the ratio of share price to book-value-per-share. The component companies have themselves to blame for some of this breakdown. They are not responsible for all of it.

They are blameless in the matter of energy, for example. As a group, the BDCs have stayed away from oil companies. The trouble is that the average public investor has not.

"BDCs are largely owned by retail investors," John Barton, paid-up subscriber and portfolio manager at Dialectic Capital Management LLC, tells colleague Evan Lorenz. "If you look at the stats for institutional holdings of BDCs, it is in the neighborhood of 25%. But, that is really misleading, because the ownership is concentrated in the big, institutional quality names, Ares being the best example. If you go away from those big, investable institutional names, the ownership in the rest of the space is largely retail. What is happening in retail land? First, in their other yield-oriented holdings, they all got blown up in master limited partnerships. I think that produced the need to sell or take down yield bets in the land of retail accounts that own all this stuff. That produced selling that didn't have another side. That's a big factor to understand."

Then, too, not every BDC does right by its owners. For instance, on April 29, the management of MCG Capital Corp. (MCGC on the Nasdaq) announced its intention to sell to PennantPark Floating Rate Capital Ltd. (PFLT, also on the Nasdaq) in a cash-and-stock transaction valued at $4.75. When HC2 Holdings, Inc. (HCHC on the Big Board) arrived to make a succession of unsolicited bids for MCG, culminating in one at $5.30 in cash and stock, MCG refused to negotiate but rather bedded down with PennantPark. "I saw the HCHC bid as clearly superior and wanted to see that deal happen," Barton remarks. "It

On the outs



source: The Bloomberg

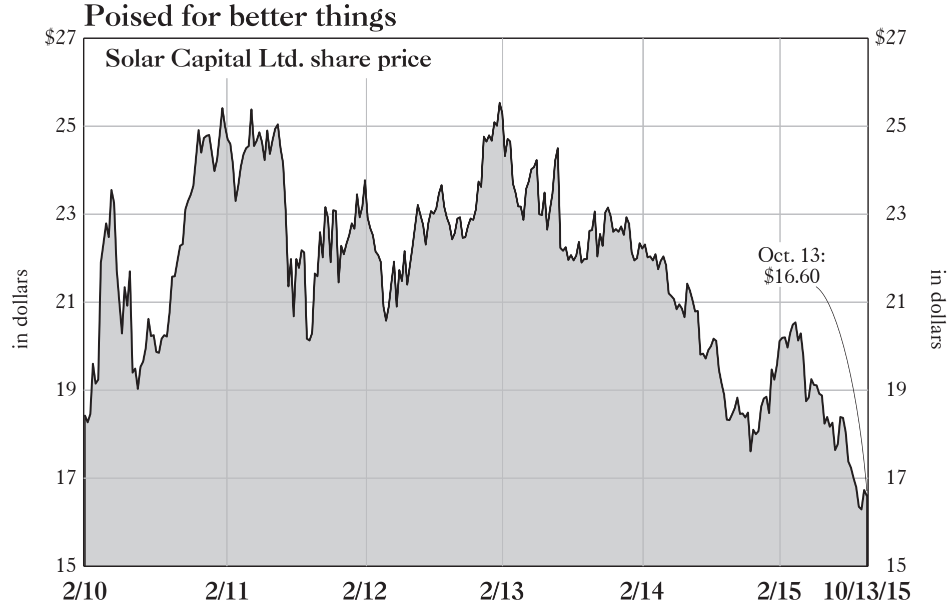
didn't." Today, the cash and shares that MCG shareholders received in PFLT are worth $4.15.

A similar story is playing out with TICC Capital Corp. (TICC on the Nasdaq), which to date has refused to engage with a would-be suitor named TPG Specialty Lending, Inc. (TSLX on the Big Board). TICC shares are quoted at $6.83; TPG would pay $7.50. Not good enough, says TICC; net asset value per TICC share is $8.60. Well and good, we say, but why not negotiate to arrive at a better price? The stockholders wouldn't mind.

Outside the control of any management is the fact that the current economic expansion, seemingly born in droopy middle age, is 75½ months old; since 1945, expansions have typically expired at 58 months. If the economy is not in recession, maybe corporate earnings are. S&P 500 earnings, which declined by 0.7%, measured year-over-year, in the second quarter, are expected to slump by 5.1% in the third. In June 2007, just before the thunder and lightning started, investment-grade corporate borrowers were carrying a ratio of debt to EBITDA (earnings before interest, taxes, depreciation and amortization) of 1.91:1. Today, as Morgan Stanley reports, they show a debt-to-EBITDA ratio of 2.29:1. The ratings agencies are issuing credit downgrades at the fastest pace since the financial crisis.

"You can't find quotes for most of the investments in a typical BDCs portfolio," Lorenz points out, "so it's difficult to see credit problems percolating until management begins the write-offs. Sometimes there's a clue as to management's predilections in this regard, as when multiple BDCs invest in the same security. For example, New Mountain Finance Corp. (NMFC on the NYSE), Prospect Capital Corp. (PSEC on the Nasdaq), and Fifth Street Finance Corp. (FSC on the Nasdaq) are the common owners of the subordinated, 10% payment-in-kind notes issued by Edmentum, Inc., a provider of online-learning programs. They don't all price it the same way. New Mountain marks its notes at 82 cents on the dollar; it says they deserve a haircut because Edmentum is electing to pay a portion of interest on these notes not in cash but in additional securities. Prospect and Fifth Street carry the same notes at 100 cents on the dollar. Maybe par is the right number. From what we know about Prospect and Fifth Street, we'd go with 82 cents (*Grant's*, Dec. 13, 2013)."

Poised for better things



source: The Bloomberg

You wouldn't guess it from their swooning stock prices, but BDCs have some enviable strengths. For one thing, they are what is known as permanent capital vehicles; their equity capital is theirs to keep, in bad times and good. They don't have to sell assets in a pinch (unless to raise cash to meet their own maturing debt obligations, in which case bets are off). The best BDCs can generate growth in book value through equity investments and the opportunistic purchase of middle-market loans. They profit, too, by strict, post-crisis regulation of commercial banks and by the ongoing shrinkage of GE Capital (the giant's exit leaves more room for mere corporate mortals to operate).

Which brings us to Solar Capital, which changes hands at 76% of book value and offers a prospective dividend yield of 9.6%. The Solar portfolio comprises senior secured loans (90.2% of the total as of the second quarter), subordinated debt (6.3%), preferred equity (1.6%) and common equity and warrants (1.9%). If ever interest rates get around to rising, Solar would be a beneficiary, as 89% of its portfolio delivers a floating yield. To judge by the June 30 report—slow loans at 0.5% of total investments—underwriting quality is top flight. There's no exposure to energy-related companies.

The 1940 Investment Company Act limits a BDC's borrowings to the sum total of its equity capital; Solar uses only 23 cents of debt for each dollar of equity. "We were repaid a third of the portfolio two summers ago," Richard Pivirotto, head of investor relations at Solar, tells Lorenz. "A third of the portfolio meant we could either put a gun to the temple of our investment team and reinvest the proceeds as quickly as possible in order to support a dividend, or cut a dividend. This was a reinvestment environment where we thought the risk had increased. So, we did the hard thing which was to reduce the dividend. This was designed to protect the net asset value. If you under-earn your dividend, you return capital and your NAV goes down." Which price Solar duly paid.

While not exactly chasing business today, Solar is committed to uncrowded niches of the middle market. Cash-flow poor, asset-rich borrowers constitute one such field of opportunity, which Solar pursues through Crystal Financial LLC, a business it acquired in 2012. Solar COO Bruce Spohler: "They developed a business where they would hire a liquidator when they were looking at a new investment and ask, 'What can you value this collateral for us if we needed to sell it under the hammer, bankruptcy liquidation? What could we get in four weeks?' The traditional asset-based lender is housed in a bank and, again, in this environment banks are criticized for having asset-based loans out to companies that have assets and not much cash flow. That would be a criticized asset and set off the alarm bells. But, Crystal says so long as I can liquidate you and get back my interest and I know how to do this, that's a great business model. They've been doing it since the 1980s." Crystal-generated loans accounted for 26% of Solar's portfolio in the second quarter.

Pharmaceutical companies and medical-device manufacturers make up another Solar specialty. "We hired the number one executive from GE Capital who ran that business [for GE]," says Solar CEO Michael S. Gross. "We brought him on board about 18 months ago. In his career at GE, he invested about $2.1 billion across that asset class with one loss of $3.6 million."

Ares, owner of one of the best long-term track records in the BDC industry, has managed to expand book-value-per-share by 21% since coming public in October 2004 (no mean trick for a type of business that must pay out at least 90% of its earnings in dividends). As of the second quarter, first-lien loans made up 32% of investments, second liens 27%, the Senior Secured Loan Program (SSLP, of which more below) 25%, senior subordinated debt 6%, preferred equity 2% and equity and other 8%. Borrowings amounted to 68 cents per dollar of equity employed; 81% of assets were floating-rate loan; and 1.3% of the portfolio was non-accruing (up 10 basis points from the second quarter of 2014).

The SSLP is a joint venture with vanishing General Electric Capital; Ares' role was to originate first-lien loans, which it would sell to the JV. The SSLP contributed fully a quarter of Ares' second-quarter footings and 36% of its income. To replace the income and fees it earns from the SSLP—the venture is today in runoff—Ares has embarked on a new senior lending program in partnership with Varagon Capital Partners and American International Group, Inc. What will become of this venture remains to be seen. How single-A-minus-rated AIG can provide funding as cheaply as double-A-plus-rated GE is not the least of the unknowns. At 90% of book value and a yield of 10%, Ares seems not quite cheap enough to compensate for the known unknowns.

Golub Capital has built its house of bricks in the shape of first-lien investments. Its own version of Ares' SSLP, called SLF, likewise deals in senior loans; it's a joint venture with RGA Reinsurance Co.

"[W]e're not moving out the risk curve," Golub said on the company's August 6 earnings call. "We've said for several quarters that we view the middle market junior debt in today's environment to be downright unattractive. We continue to hold that belief, and we remain focused on our strategy of some standing now of focusing on first line senior secured loans and one-stops [blended junior and senior credits]."

At last report, virtually all Golub's investments were floating rate and all but trace amounts of the portfolio were accruing interest (non-accruals were 0.2% of the portfolio). Is the portfolio safe enough to absorb substantially more leverage than either Ares or Solar lay on? Golub so judges. On June 30, debt amounted to $1.03 of debt for every dollar of equity (as the regulators do the sums, the leverage ratio comes in under the 1:1 allowable maximum). Since coming public in April 2010, Golub has bumped up its book-value-per-share by 7%.

It's a pity that Golub's exemplary record is no secret. The shares trade at a 4% premium to book value and yield a prospective 7.8%.

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