GRANT'S

INTEREST RATE OBSERVER®

Vol. 35, No. 20c | Two Wall Street, New York, New York 10005 • www.grantspub.com | OCTOBER 20, 2017

Sun shines

With respect to the shares of business-development companies, Mr. Market seems to smell a rat. In a year in which the S&P 500 is up by 14%, the S&P BDC Index is down by 4.7%.

Which will serve to introduce, or rather reintroduce, Solar Capital Ltd. (SLRC on the Nasdaq), a different kind of BDC and a happy outlier in this time of general BDC disenchantment. So far in 2017, Solar's shares have rallied by 3%. In the past two years, they have delivered a gain of 48%, counting dividends. "Now what?" is the question before the house. To anticipate, *Grant's* remains bullish.

BDCs, as you'll recall, are closed-end funds that invest in—mainly lend to—middle-market companies. As a class, they lend in support of private-equity transactions, so they can't help but bear a certain amount of credit risk. Regulated by the Investment Company Act of 1940, they may employ debt equal to one times equity, no more. Like mortgage REITs, they earmark 90% of their net income for dividends to their income-deprived shareholders.

When Solar previously featured in these pages (the date was Oct. 16, 2015), its shares traded at 76% of book value and offered a 9.6% dividend yield. The steep discount to book reflected the general disapproval of management's decision to cut the dividend, curtail exposures and dial down leverage in the face of rising risk. Vindication of that judgment takes the form of today's valuation of 98% of book and a dividend yield of 7.5%.

Presuming to read Mr. Market's mind, we judge that the gentleman is worried about tight lending spreads, white-hot competition to lend (despite restrictive banking regulations), an aging credit cycle and vanishing covenant protection. Well, he should be—the facts are the facts, and they bear on Solar as they do on the rest of the field. What distinguishes Solar is, to us, its diversified book of business, favorable credit experience and risk-averse, value-minded management.

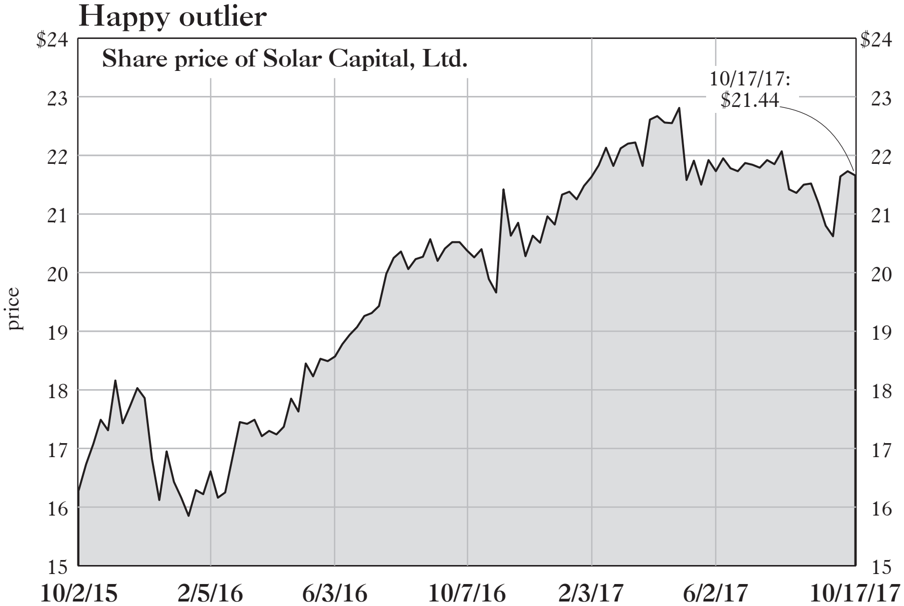
The Solar investment portfolio foots to $1.7 billion and comes in three parts: asset-based loans ($713 million); life-sciences-related loans ($215 million); and plain-vanilla and private-equity-related loans as well as equity-linked investments ($788 million).

An asset-based credit is a loan against collateral rather than cash flow—against, for instance, the collateral of excavators, tractor-trailers or milling machines of the computer-numerical-control variety.

The life-sciences division lends to closely held pharmaceutical and medical-device companies. Do you wonder why such a borrower would have recourse to a Solar loan rather than another round of venture-capital funding? Because the loan, even at interest rates in the teens, is cheaper than the VC alternative. The former GE Capital executive who heads the division, while at mothership GE, originated $2.1 billion worth of such loans with exactly $3.6 million in losses, according to Solar.

The other 46% of Solar's portfolio—the private-equity-themed portion—looks more like the standard BDC competition. Of the aforementioned grand total of PE-related exposure, $513.8 million comprises senior secured first liens and $242 million consists of unitranche

Happy outlier



source: The Bloomberg

loans (i.e., a single note that combines both first- and second-lien loans). Solar's sole exposure to the junior-most segment of the corporate capital structure is $31.9 million in equity, warrants and other equity-like claims.

Solar was founded in a 2006 partnership of Michael Gross, today's CEO and chairman, and Bruce Spohler, today's COO (the partnership went public in 2010). "The lack of maintenance covenants that has crept into middle-market direct lending is probably the biggest change in our careers," Spohler tells colleague Evan Lorenz. "Leverage levels and pricing ebb and flow through a credit cycle, but it's really been the lack of documentation in this cycle that has been been most concerning."

"The key point," Spohler goes on, "is to have maintenance covenants so you can actively monitor your loan investment. If you're cov-lite, all you can do is hope to get your interest payment every quarter and your nominal principal payment until the loan is repaid. So you're a passive investor unable to really impact your outcome until there is a payment default. Having maintenance covenants gets you to the table early and allows you to re-underwrite the credit, and re-price the risk as appropriate."

So far, so good: As of June 30, Solar showed one nonperforming loan, which was equal to 0.7% of the portfolio on a cost basis but was written down to zero on a fair-value basis. Pro forma the July 31 acquisition of NEF Holdings, LLC, an equipment lender which specializes in short-term, fixed-rate credits, 77% of Solar's portfolio consists of floating-rate investments. All the more reason, adds Gross, to select the kind of borrower that can keep its cash flow growing in sync with the (prospective) rise in borrowing costs. "That's where we've positioned our portfolio," he says.

Scanning the list of potential BDC investments, alphabetically arranged, you start with Ares Capital Corp. (ARCC on the Nasdaq), owner of one of the best long-term records in the industry. Ares is big, with a $11.5 billion portfolio, and optically cheap: The shares change hands at book value, as do Solar's, but yield 9.2% compared to Solar's 7.5%. We judge that the market is right, as Ares is more leveraged than Solar (0.7:1 vs. 0.55:1) and far more heavily exposed to credit risk. At last count, the sum total of second-lien credits, subordinated debt and various flavors of equity amounted to 53% of the Ares portfolio.

As for Golub Capital BDC, Inc. (GBDC on the Nasdaq), itself an exacting underwriter, it commands an 19% premium to book value and a yield of 6.7%. Taking one thing with another, we judge Solar good relative value.

We have no answer to any who question the advisability of investing in even a well-managed BDC at this frenzied financial moment. For readers who require no investment income or who would hate themselves (and us) for reliving the experience of the previous credit liquidation—peak to trough, the Ares share price plunged by 84%—we might suggest to stay away.

Then, again, for the many who do need income, or who entertain a sunnier outlook on credit than your editor, Solar may appeal for many reasons. One is that its diversification away from private-equity lending gives management the latitude to expand in less competitive parts of the marketplace.

"Thus," Lorenz relates, "in the three months ended June 30, Solar's PE-sponsored book of loans declined by $140.8 million as new originations of $20.8 million were not enough to offset $161.6 million of prepays and divested loans. The average loan on the book of NEF, one of the asset-based lending subsidiaries, is only $2.3 million in size, far too small to move the needle for public BDCs. It takes time and investment in operations to build an origination team in this sub-sector of finance, but after that, investment companies like NEF can grow in the $270 billion equipment-finance market."

"Solar remains one of the most disciplined credit investors in the entire BDC sector," National Securities Corp. analyst Christopher Testa opines in an Aug. 7 advisory. "Management has had no issue with permitting the portfolio to shrink even if it means earnings come in light. We respect that Solar is not managing the company for the next 90 days, and this is reflected in the pristine asset quality and stable NAV share."

Except for the NEF acquisition, Solar's leverage would register at 0.32:1 rather than 0.55:1. On past conference calls, management has indicated an intention to target leverage in the range of 0.65:1 to 0.75:1. At the higher end of the band, the company could, perhaps, lift quarterly net investment income into the upper-40 cents per share vs. the latest reading of 38 cents. Conceivably, then—a speculation, of course—the NEF acquisition may allow Solar to contemplate raising quarterly distributions just as many other BDCs are considering lowering them.

The Street is evenly split on the stock with four buys and four holds. Not part of the Street, except for our postal address, we throw our weight to the bulls.

•