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‘Last to lose’

Evan Lorenz writes:

Despite almost doubling in the past five months, to 7.64%, speculative-grade corporate bond yields still fall short of the 8.3% leap in April’s Consumer Price Index. An income-seeking investor, capable of bearing a businessman’s risk, may be excused for wondering if there exists an inflation-beating yield in the whole wide dollar-denominated world. In preview, we reiterate our bullish view toward an old *Grant’s* favorite, SLR Investment Corp. (SLRC on the Nasdaq), formerly Solar Capital Ltd.

SLR is a business-development company, or rather, as the people who run it prefer to say, a “commercial finance company in a BDC wrapper.” It’s a specialized lender against assets and cash flows alike.

We last looked in on SLR during the despairing Covid time of two springs ago (see the issue dated March 20, 2020). Repaying our confidence, the shares have subsequently returned 83.1%, compared with 76.8% for the S&P 500 (in both cases with dividends reinvested). The run-up in the stock price notwithstanding, SLR today boasts an 11.2% dividend yield and trades at 0.75 times book value. For reference, the S&P BDC Index changes hands at a 10.1% dividend yield and is quoted at 0.92 times book.

A couple of things have changed at SLR over the past two Marches. First is a first-quarter credit loss this year and the fact that net interest income no longer covers the dividend (of which more below). Second is the 2021 name change, which formalizes SLR’s merger with its sister BDC, SLR Senior Investment Corp.; now the two, which had already shared the same external manager, are one.

“We originally created SLR Senior in 2011, a year after the IPO of SLRC,” co-CEO and chairman Michael Gross tells me. “It was built and created to do traditional first-lien risk. At the time, SLRC was much heavier in second-liens. Over the past 10 years, the businesses have morphed closer to each other, i.e., the portfolios have a lot of overlap. SLRC became almost all first-lien, senior secured. The portfolios both yielded around 10%. They were really no longer different products from an investor’s perspective.”

Combining the two entities allows SLR to issue larger loans as well as to slash duplicative costs. After the merger closed, to acknowledge the shareholders’ voting to bless it, SLR put through a 25 basis-point reduction in its management fee, to 1.5% of net assets.

Post-merger, SLR looks after a $2.66 billion investment portfolio that’s broadly diversified across specialty finance: 23% in middle-market loans, i.e., credits to leveraged borrowers too small to tap broadly syndicated bank loans; 21.5% in equipment leases, primarily to investment-grade customers; 17.7% in asset-backed loans, frequently secured by a customer’s inventory; 12.7% in loans to late-stage life-sciences companies; 12.8% in businesses that lend against customers’ accounts receivable; and 11.9% in equipment financing, primarily short-term loans to small- and medium-size business.

Fully 96.3% of investments are first-lien securities and 64% of the portfolio is in floating-rate paper. The meaning of “first lien,” as Bruce Spohler, co-CEO and chief operating officer, reminds us, is that, “knock on wood, we are the last to lose money. That doesn’t mean that we can’t lose money, but it does mean we are last in line. That’s great. We are in defensive sectors in our cash flow business [the segment that extends credit to leveraged businesses, usually the kind that sit in the portfolios of private equity promoters]. That’s great. We are in a lot of collateralized lending, 70% plus if you include life sciences. That’s great. We are floating-rate. That’s great”—especially great, Spohler notes, in a time of inflation and rising interest rates.

The merged company employs almost 300 people today, up from 200 or so two years ago. Lending capacity, too, has grown: “When a company comes to refinance,” says Gross, “whereas in the past we could do $100 million, today we can do $200 million.” Maximum leverage allowed to BDCs is $2 for each dollar of equity; SLR today deploys 90 cents.

It’s well and good to share in the bounty of the private equity boom, as SLR has done. It’s even better, as financial markets retreat, to have other business segments on which to fall back. In all its forms, asset-backed lending comprises 64% of the portfolio excluding the life-sciences division and 77% including that unit.

“We have a specialty business that just does it for health care,” says Spohler, “which is a special art. You need to know that not every receivable is going to be worth 100 cents of collectability, depending on the state, the service, whether it is anesthesia or surgery or dentistry."

Factoring is another of SLR's non-cash-flow lending lines. "You have a lot of small companies that may not have strong credit," Spohler goes on, "but they have strong receivables where they do business with customers who might be investment-grade and say, 'We will pay you when we get around to it. It might take six months.' The small companies say, 'We can't wait that long.' So they factor the receivables at SLR at 85 cents [on the dollar] and take a 15-cent hit. That will be a cost of goods sold for a small business. We get very high-quality risk in terms of investment-grade receivables from big companies by virtue of buying those receivables and having the patience to wait three to six months."

Prior to last quarter's loss, SLRC had been in the process of selling its last second-lien loans. It did not manage to sell a junior loan issued to PhyMed Management, LLC, which provides hospitals with outsourced anesthesia services. Owing to a change in insurance reimbursement rates, SLR wrote down its loan to PhyMed to $18.9 million from a cost of $37.8 million. As a result, book value per share fell to $19.56 in the first quarter from $19.93 on Dec. 31, 2021. After this writedown, second-liens make up 3.3% of the combined portfolio.

Rising rates and the merger fix most of the income shortfall. On the enlarged equity base, the management-fee reduction works out to $2.7 million per year in savings or $0.05 per share. Since March 31, the three-month Libor rate has increased to 1.52% from 0.96%. That rise in rates should result in $9.2 million in extra income (0.56% multiplied by the $1.7 billion of the portfolio comprised of floating securities), or $0.17 per share. Combined, the fee cut and the bump in rates should work out to $12.2 million in extra income, or $0.22 per year. In the first quarter, SLR paid out an annualized $1.64 in dividends per share and generated an annualized $1.40 in EPS after adjusting for merger expenses.

SLR, a Baa3/triple-B-minus credit, i.e., barely investment-grade, has adroitly navigated the spasm in rates. To refinance a $150 million issue of unsecured 4.6% notes due May 8, 2022, SLR raised $185 million in a pair of bond sales in November and January at an average coupon of 3.2%. "We have developed a great source of financing on the senior unsecured side by doing private placements with insurance companies as opposed to going to the public markets," Gross tells me. "What that has allowed us to do is be more flexible on the sizing of transactions, because the public market usually requires bigger deals, without impacting rates at all."

Management, which owns about 8% of SLR shares outstanding, announced a $50 million share repurchase program earlier this month versus a market value of $804 million.

Six of the nine analysts who cover SLR call it a buy; none says sell and the short interest sums to less than 1% of the equity float. Says Gross of his favorite stock: "We think it's cheap. We are trading at 0.75 NAV today. . . . We thought it was a great value at NAV. When we are in a position that we are no longer restricted, we are going to use the stock buyback program we have in place."

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