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Pull to book value

Evan Lorenz writes:

"We're no longer in a free money environment," Apollo Global Management, Inc. co-president Scott Kleinman observed on Bloomberg TV last week. "Our industry is going to have to go back to good old-fashioned creating value through good old-fashioned operational improvement, buying well [and] finding good, underloved companies."

Lenders to private equity, the opportunities surfaced by the springtime retreat of the regional banks and a Cook's tour of the post-free-credit situation are the topics at hand. In preview, we remain bullish on SLR Investment Corp. (SLRC on the Nasdaq), though widows and orphans may prefer Treasury bills.

The EZ-money era was a tide that lifted all boats, even the ones with holes in the bottom. Between 2017 and 2021, according to a 2022 analysis by Cepres GmbH, "multiple expansion accounted for 56% of value creation in the average deal" while revenue growth chipped in an additional 38% and margin expansion delivered 6%. Rising valuations and ready access to credit meant that problem borrowers could refinance their way out of a jam. "Golly, how did the lenders achieve such low default rates?" an extraterrestrial visitor might innocently wonder.

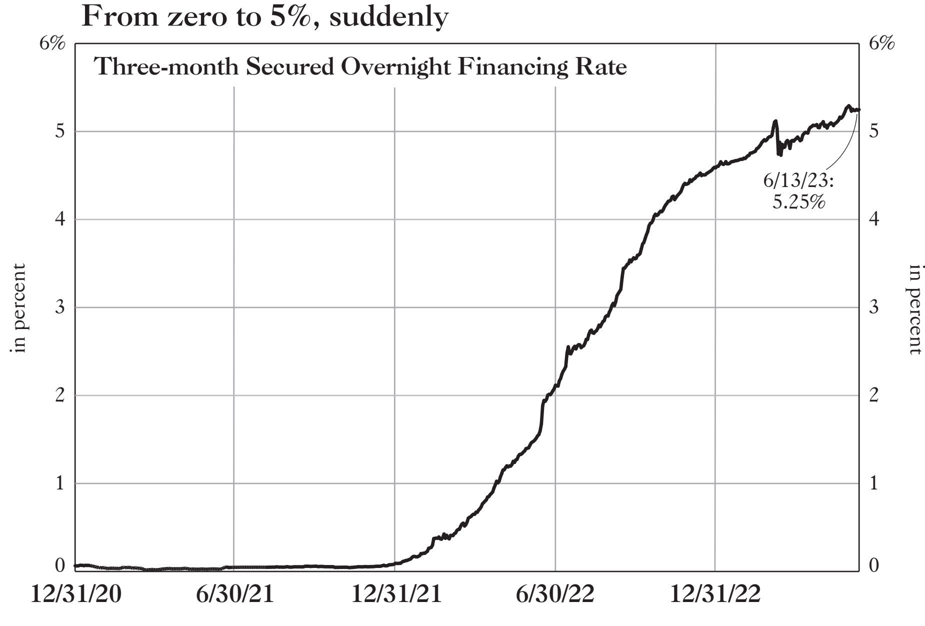
Of course, there's more than one way to finance a buyout. High-yield bonds and tradable bank debt (a.k.a. leveraged loans) are the leading public-market options. Non-traded loans issued by business development companies and direct lending funds are two private-market alternatives. The first quarter, though, featured little variety: Private credit funded 70% of private equity transactions, according to Carlyle Group, Inc.

The marginalization of medium-size American banks helped to drive this lopsided outcome, but the Citis and Morgans may not get off scot-free, either. According to the June 6 edition of *The Wall Street Journal*, the Federal Reserve, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency are weighing new restrictions on banks with more than $100 billion in assets. Say what you will about safety and soundness, a 20% boost in the capital requirements of large banks would delight no lord of leveraged finance.

Also unhelpful, in its paradoxical way, is news that Ares Capital Corp., the big business development company, sold 25.3 million shares in the first quarter for proceeds of $494.1 million. Such sizable financing events usually presage a surge in investments, as an analyst pointed out on the April 25 call, but Ares's portfolio actually contracted in the first quarter. Why? A few anticipated deals failed to materialize, CEO Kipp deVeer acknowledged, and, besides, Ares had "higher leverage" and was "looking to deleverage a little bit."

While private equity deal volume fell by half in the first five months of 2023, measured year over year, to $192.9 billion, according to S&P Global Market Intelligence, the deals that did make it to the desks of private lenders offered better returns than the market's been accustomed to. With the three-month Secured

From zero to 5%, suddenly



source: The Bloomberg

SLR Investment Corp. at a glance
all figures in $ millions except per share data

	TTM*	2022	2021	2020	2019
investment income	$198.0	$177.5	$139.4	$121.7	$154.7
total expenses	113.0	101.1	78.4	62.5	82.3
net investment income	85.0	76.4	60.9	59.2	72.4
realized and unrealized losses	61.3	58.0	1.4	43.8	16.4
net income	23.7	18.3	59.6	15.5	56.0
earnings per share	0.44	0.35	1.41	0.37	1.33
shares outstanding	53.9	51.9	42.3	42.3	42.3
debt	1,115.5	1,086.0	812.0	671.5	587.1
equity	984.2	999.7	842.3	852.0	905.9
total assets	2,556.2	2,537.7	2,011.0	1,936.0	1,949.9

* For the 12 months ended March 31, 2023.

source: company reports

Overnight Financing Rate at 5.25% today versus 0.09% at year-end 2021, and with wider loan spreads against that higher SOFR base rate, first-lien private loans fetched between 11% and 13%, Armen Panossian, the CEO of Oaktree Specialty Lending Corp., told his May 4 earnings-call audience.

Old-fashioned equity funded 50% or more of p.e. deal values this year compared with the usual 35% or 40%, Panossian added. "So," he went on, "I would say that it's just a better-quality market, and we're getting some really nice returns in new issue loans in the low double digits without having to stretch for junior instruments in the capital structure."

One might suppose that private credit, today's favorite asset class (see the prior issue of *Grant's*), would spoil the opportunity by lending too aggressively—and about 15 or so months ago, it seemed to be doing just that. To slake a still-ferocious thirst for yield, Wall Street raised billions of dollars for such retail-oriented income plays as the Blackstone Private Credit Fund. Enough was raised, in fact, to reprice the market, SLR Investment co-CEO and chairman Michael Gross tells me, and such was the nature of the new investment structures that the money went right to work, with the associated leverage, as soon as it was received (and not when, as in the case of so-called drawdown funds, the portfolio managers decide that there's something worth investing in).

So, yes, while 2023-vintage private buyout loans are appealing enough, they're not the ones that fill the credit books of most private lenders. Boomtime assets rather predominate, the kind acquired when rates were low and bullishness was boundless.

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Which brings us to SLR Investment, a business development company by genus and species whose commitment to middle-market credits (i.e., leveraged borrowers that are too small to access the syndicated bank-loan market) makes up just 23.3% of its $2.9 billion loan book. We say "just" because the typical BDC is 100% exposed, through debt or equity, to the capital structure of leveraged borrowers.

With the balance of its portfolio, Solar invests in asset-backed loans, with collateral ranging from real estate to machinery and accounts receivable (33.3% of the total); equipment financing, primarily to investment-grade customers (32.1%); and life-sciences loans (11.1%; on which, more later). At the close of the first quarter, the troubled, or "category 4," portion of the investment portfolio, i.e., the segment that's "performing well below expectations and...not anticipated to be repaid in full," summed to 0.3%.

First-lien loans make up fully 98.6% of SLR's portfolio, and 65.6% of its credits are floating-rate. (The equipment finance division is mostly fixed-rate.) At the end of the first quarter, SLR employed $1.12 of debt for each dollar of equity; under the law, it might have gone as high as $2 of debt per dollar of equity.

Even so, SLR suffered a bigger drawdown in net asset value over the past several years than did the BDCs that focus almost entirely on highly leveraged companies. Thus, from year-end 2019 through the first quarter of 2023, SLR's book value per share sank by 15.9%, to $18.04. This compares with drawdowns of 11.6% for Golub Capital BDC, Inc. and 13.8% for Goldman Sachs BDC, Inc.

The explanation for the poor performance lies, in the first place, in a pair of underwriting mistakes. Of the $3.40 decline in book value per share, more than $1 is attributable to a second-lien loan to PhyMed Management, LLC, a provider of outsourced anesthesia services, and to a first-lien loan to IHS Intermediate, Inc., a vendor of corporate health and wellness programs. These losses will not be recouped.

Trimming sails when the virus struck, management allowed its investment portfolio to shrink. A 17% decline in earning assets in the first nine months of 2020 rippled through the financial statements, dropping leverage to as low as 0.56 times (compared with the current 1.12) and reducing income such that it fell short of the quarterly dividend payout. Management opted to bridge the gap between income and dividends by returning to the stockholders a bit of their own capital.

SLR began covering its dividend payments again in the fourth quarter of 2022. "There was an over-distribution, which was probably 60 cents per share of the $3 delta in book value," SLR's co-CEO and chief operating officer, Bruce Spohler,

SLR Investment comps

	market cap. (in $ mns)	price-to-book ratio	dividend yield	change in NAV per share
Ares Capital Corp.	$10,374.3	1.03x	10.1%	6.5%
Golub Capital BDC, Inc.	2,303.0	0.91	9.7	-11.6
Goldman Sachs BDC, Inc.	1,542.3	0.98	12.8	-13.8
SLR Investment Corp.	794.9	0.81	11.3	-15.9

sources: The Bloomberg, company reports

tells me. "By regrowing the earnings, we expect to be under-distributing over the next couple of years and rebuilding our net asset value"—as the government allows. The law which holds that, to maintain its tax status, a BDC must annually pay out at least 90% of its earnings, does not foreclose the option to squirrel away some income on the corporate balance sheet. For example, $1.19 of Ares's $18.45 book value per share consists of undistributed earnings.

Some unrealized losses are irreversible, others are hypothetical. As to the latter, SLR houses its non-middle-market operations in specialty finance company subsidiaries, which, Spohler explains, "are valued based on comparables." With regional banks trading off, a sympathetic mark-to-market on the so-called FinCos is obligatory. "If you look at where each of those FinCos were at their peak," Spohler goes on, "that'll get over $1 of NAV in terms of reversing those marks. So we see a clear path to getting back to that $21-plus range in NAV per share between growing earnings, recovery of the marks on the FinCos and pulling to par on the existing portfolio, where we are issuing loans at $97 and accreting them up to par [when they pay off]."

Ironically, while the problems at regional banks have driven down the marks on SLR's specialty finance units, those divisions see much brighter prospects thanks to the very same turmoil. Life-sciences lending is an example. In this segment, SLR lends to pharmaceutical and medical-device companies, which, though early-stage, have secured regulatory approval for their products.

Why, then, were the sponsors of these companies willing to borrow at an average rate of 12.8% in the first quarter? Because, according to SLR, the debt was cheaper than dilutive equity capital and the proceeds can, with luck and pluck, tide over a new business until it begins to generate cash flow.

"Silicon Valley Bank was one of the five or six players in life-sciences lending," Spohler tells me. "Obviously, with their demise, we're just seeing more of an opportunity set. It's not that SVB was competing at lower pricing, although they did have a lower cost of capital. They just had more flexibility in their structures, and they had the ability to bid prices down a little bit because they made money on the cash management for their borrowers and the venture capital managers."

The pullback of regional banks and the general tightening of lending standards created better opportunities in the asset-backed lending unit. "Companies that historically may have been able to access [private credit] are unable to do so because of volatile earnings," says Gross. "So they're faced with having to raise capital in the asset-backed lending markets."

Regional banks, with their formerly low cost of capital, dominated asset-backed lending. "If they wanted to do a deal," says Spohler, "they would generally win. They would be a couple hundred basis points lower on price. It wasn't even a close call. Today, they are just not in the business. What we're finding is that we can win the ones we want to win at attractive pricing. Importantly, we're also not facing the headwind of refinancing, because very often our borrowers would come to us in our specialty finance segment and say, 'Well, so-and-so regional bank has approached us to refinance you. Do you want to stay in?' So it is a combination of being able to win new investment opportunities without the regional bank competition and keeping assets longer."

Anemic deal flow or not, there are opportunities in lending to private equity portfolio companies. "The bulk of what we were seeing is add-ons, which allows us to go into mature buyouts and capital structure we're already familiar with, but at a discount to where the original financing was done," according to Gross. "If they want to do an add-on acquisition, instead of doing a whole new credit facility, which will force them to reprice their entire debt, they'll add a piece pari passu to the existing facility, and just add some additional [discounts] to it to allow us to price it to 13%, whereas the original price might have been 7%."

At 81% of book value and offering an 11.3% dividend yield, SLR's shares are priced for further book-value erosion. We judge it more likely that book value will grow. Since we had our say on the stock in the issue dated May 27, 2022, SLRC has eked out a 3.2% gain, underperforming the 6.9% uplift in the S&P 500 (both figures include reinvested dividends).

Nevertheless, the Street is broadly friendly, with four of the nine analysts on the case saying buy and only one dissenting sell. Short interest is de minimis at 1.5% of the equity float. Insiders purchased a net 3,908 shares over the past 12 months at a cost of $58,512. In addition to which, SLR Capital Partners, LLC, the BDC's management company, purchased 250,473 shares on the open market at a cost of $3.9 million for long-term incentive compensation plans.

"For a variety of reasons, the opportunity set is probably the best we've seen in quite some time," Spohler concludes. "Probably going back several decades. As you know, Michael and I have been doing this for over 35 years."

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