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Risk and reward

A loan is a loan, unless it's a so-called leveraged loan. Or unless it's a claim on a private, middle-market, smallish company whose name you have perhaps never heard. Now in progress is a survey of the perils and opportunities in middle-market lending.

Clarity first. A leveraged loan is usually a bank product; having extended a credit to a speculative-grade business, the originating bank syndicates it in the shape of tradable senior secured claims.

The private middle-market loan is a kind of do-it-yourself product; having extended a credit, also to a speculative-grade business, institutional investors retain it on their own balance sheets. They thus bypass the banks, which, for the most part, have been happy to be bypassed, the burgeoning demand for deal-related credit notwithstanding.

The middle market is illiquid and opaque. To compensate for the flaws, borrowers pay high interest rates and submit to tight loan covenants—higher rates and tighter covenants, at least, than the ones quoted in the larger, better-known leveraged-loan market. (Not that these definitional distinctions are ironclad—Ares Management Corp., a publicly listed firm and one of the biggest middle-market lenders, happens to syndicate the loans it originates.)

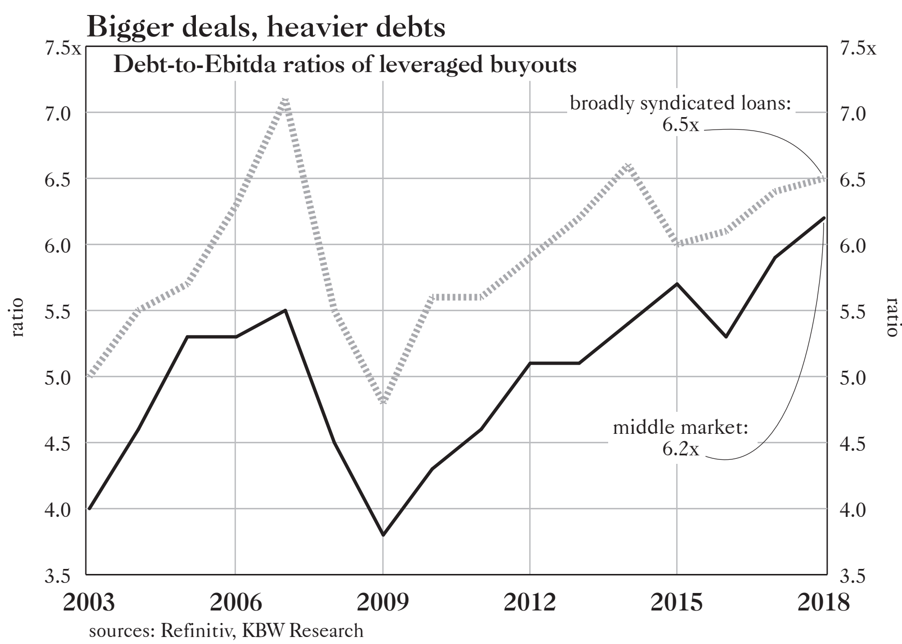
Business-development companies are the investor-owned face of private middle-market debt. A pair of leading BDCs, Solar Capital Ltd. (SLRC), Golub Capital BDC, Inc. (GBDC, both on the Nasdaq) and an assortment of BDC "baby bonds" are the securities under the *Grant's* lens. We're bullish on each, though wary of both the income famine and the private-equity boom that's behind the outpouring of middle-market corporate debt.

The leveraged-loan market weighs in at $1.1 trillion, and its middle-market counterpart isn't far behind. Thomson Reuters LPC and Preqin, Ltd. guesstimate it measures $800 billion. Bloomberg, citing data from Preqin, reports that direct-lending funds have raised $19.4 billion in the year to date, up from $11.6 billion in the same stretch a year ago. You don't need the data to see that investors continue to reach for yield, the evident lateness of the cyclical hour notwithstanding.

Private middle-market borrowers tend to be smaller and less heavily encumbered than their leveraged-loan counterparts. Expressed as an average ratio of debt to earnings before interest, taxes, depreciation and amortization over the past five years, the privates are indebted 5.7:1, the issuers of leveraged loans, 6.3:1, according to LPC and KBW Research data.

Even so, lower leverage translates into higher yields. Over the same half-decade, measured as a spread of borrowing cost to Libor, private mid-market borrowers paid an average of 476 basis points, the issuers of leveraged loans, 376 basis points. The privates paid more because they are smaller and therefore, statistically, more prone to failure.

As for illiquidity risk, Ryan Lynch, analyst at Keefe, Bruyette & Woods, Inc., tells colleague Fabiano Santin, it may be overrated. "A lot of people are fine with taking that illiquidity risk," says Lynch. "We see a lot of institu-



tional consultants, guys who consult for pensions, endowments and insurance companies, who are now recommending people to allocate a larger percentage of their allocation to middle-market and direct lending. I don't see that changing anytime soon."

Whatever one may say about the value of the consultants' imprimatur, David Golub, founder and president of Golub Capital, sounds a cautionary note. "What's happened in private debt is no different from what's happened in a whole bunch of other categories that one might call risk-capital categories," he tells Santin. "Large amounts of investor capital have flowed into private debt in the last five years, but I think institutional investors now understand that middle-market lending is not something that you can do successfully with a couple of guys with cell phones in a garage. This is a business that is going through a maturation curve, and the winners are the firms with large, sustainable competitive advantages."

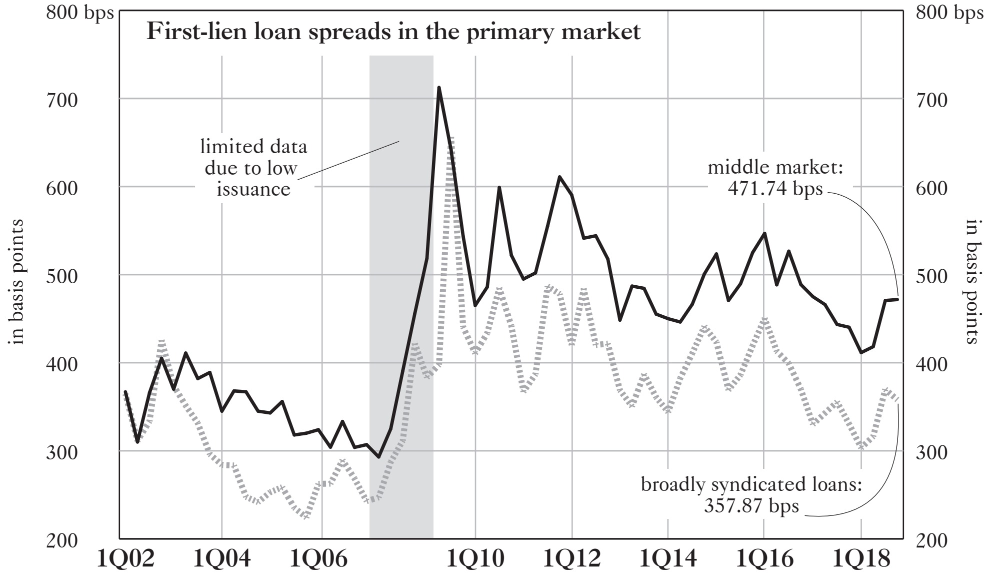
Few are so blessed in any industry, but the BDC industry is notable for the sharp delineation between its winners and losers. Of the 40 or so BDCs with enough market cap to engage investors' attention, at least a half-dozen have struggled even in this bull market. Thus, over the past five years, counting dividends, investors in Medley Capital Corp. have suffered losses of 50%. Over the same span, shareholders of the former Triangle Capital Corp. (now Barings BDC, Inc.), Capitala Finance Corp., Alcentra Capital Corp., THL Credit, Inc. and the former Fifth Street Finance Corp. (now Oaktree Strategic Income Corp.) have borne losses of between 5% and 27%.

"Overall," comments a knowledgeable observer, "BDC results have been kind of yucky, and the reason is that about half of the BDC universe has significant credit issues in their portfolios."

The Wells Fargo Business Development Company Index has returned 6.9% annually since Oct. 1, 2004. It's below the 7.4% produced by high-yield bonds but more than the 4.8% earned by leveraged loans. Of course, the comparisons are inexact. The BDC index measures the share-price and dividend performances of the companies that invest in middle-market loans, not those of the underlying claims.

The *Grant's* pick-to-click Solar Capital has built niche lending businesses in equipment finance, the life sciences and asset-based claims, i.e., lending against the collateral of inventories and receivables. The portfolio foots to $1.8 billion, the share count to 42.2 million and stock-market cap to $908 million.

Size matters in interest cost



sources: Refinitiv, KBW Research

No optical bargain, SLRC changes hands at 0.97 times book value to deliver a dividend yield of 7.7%. In the past five years, the fund has generated a return on equity of 6.7%; last year's was 7.3%.

As of Dec. 31, Solar was invested in first-lien loans (87.1%), second-lien loans (11.2%) and equity and equity-like securities (1.7%). There were zero loans in non-accrual status. Leverage totaled 0.5 times equity, well below the maximum of 2:1 allowed to BDCs under the law; management says it intends to boost its borrowings to a range of 0.9 to 1.25 times equity when conditions warrant. It likewise seeks to keep increasing the share of the portfolio devoted to first-lien loans (they rose by almost three percentage points in the second half of last year) as well as to reduce exposure to private-equity promotions, which fell to 26% of the portfolio from 43% in 2017.

"This is not for inexperienced investors," Bruce Spohler, chief operating officer, tells Santin about the art of middle-market lending. "Asset-based lending and specialty finance have high barriers to entry in the form of deep expertise and experience underwriting through multiple cycles.

"And some of these niche businesses are not scalable to the extent larger institutional lenders would prefer," Spohler goes on. "There is nothing special about committing to a loan facility. It's about underwriting, loan structure and extensive due diligence of the collateral underlying the loans. We have teams of approximately 20 dedicated professionals in each of these business segments who have on average over 20 years of experience across multiple cycles of underwriting, evaluating and monitoring collateral."

Golub Capital BDC is the acknowledged class of the industry and trades accordingly. For years, this publication has withheld its blessing from Golub shares on account of valuation. But, as Santin puts it, "recognizing that premium's persistence and the perennial need for income," we hereby capitulate. At 1.15 times book value, we pronounce Golub a reasonably valued source of investment income in a market barren of absolute value. A prospective investor should be aware of another wrinkle: While Solar is reducing its private-equity lending, Golub is all-in: 100% of its book derives from p.e. transactions.

On Nov. 28, GBDC announced its intention to merge with stablemate Golub Capital Investment Corp. (GCIC), a privately held BDC. The combined entity boasts $3.5 billion in assets under management and will become the fourth-largest BDC. As the assets of the fused companies will be similar to those of the separate ones, there will be no differences in credit, pre- and post-tie-up. However, as some accretion in NAV will favor the public shareholders, the reshuffling looks like a win for both sets of investors (the private owners get liquidity and can expect to see their NAV trading at a premium to book immediately, while the terms of the exchange favor the public holders). After the merger, book value per share is projected to rise to $16.64 from $16.04 at the end of December, which would reduce the current stock valuation to 1.1 times book value, according to Christopher R. Testa, senior analyst at sell-side firm National Securities Corp.

"Golub shareholders have earned the premium, given the firm's average ROE of 8.8% over the past five years," Santin observes. "The default rate portfolio has averaged 0.9% in the past 15 years, compared with 2.8% for leveraged loans. GBDC dates only from 2010, but five Golub credit funds passed through the fires of 2008. They survived it, according to a private 2012 Golub presentation to an institutional investor, with only one of them generating a negative return (down 6.6% in the year of Lehman). But that one fully recovered in the following year with an upside lurch of 22.5%. Today's 7% dividend yield stands to become slightly fatter post-merger, as the board is on record with the intention to boost the 33-cents-per-share payout after the transaction closes."

As of Dec. 31, Golub's $1.92 billion portfolio was invested in 212 companies, 80% of which had availed themselves of the Golub "one-stop secured loan," a type of credit that combines a first-lien and a second-lien into one obligation. Another 13% of the portfolio was allocated to first-lien loans, the balance to second-lien loans (1%), equity (2%) and an investment in a senior loan fund (4%) managed in partnership with RGA Reinsurance Co.

Non-performing loans in the portfolio represented 0.3% of the portfolio, flat quarter-over-quarter. Golub, like Solar, anticipates laying on more leverage when the cyclical time is right (it carried one times debt-to-equity at year end). And, like Solar, Golub insists it builds a portfolio diversified across resilient, non-cyclical, non-capital-intensive industries—even if the portfolio companies do happen to have sprung from private-equity deals.

"We've been preparing for a downturn for the last several years; arguably we've been too cautious," David Golub tells Santin. "And so our portfolio is skewed to resilient companies in resilient industries. I think if you look at the last couple of quarters for BDCs you can see a lot of dispersion in credit results."

Following is an assortment of baby bonds for investors who wish to make small commitments at the top of the BDCs' capital structure, rather than at the bottom. They are:

- Hercules Capital, Inc.'s 6¼s of 2033 (CUSIP: 427096847; triple-B-rated; $40 million outstanding), priced at $25.07 for a 6.2% yield to the next call on Oct. 30, 2023, or a current yield (technically, it's the "stripped" yield, which is almost, but not quite, the same) of 6.2%. The value of the portfolio assets would have to be sawed in half before the bonds became impaired.
- Oxford Square Capital Co.'s 6¼s of 2026 (not rated; $42.5 million outstanding), quoted at $24.94 for a 6.4% yield to the next call on April 30, 2022, or a current ("stripped") yield of 6.3%. It would require a 68% shrinkage in portfolio assets to impair the bond.
- Prospect Capital Corp. (CUSIP: 74348T110; triple-B-minus-rated; $50 million outstanding), priced at $25.01 for a 6.7% yield to the next call on Dec. 15, 2021, or a current ("stripped") yield of 6.8%. It would take a 56% markdown in the portfolio before the bonds were dinged.

"The economy seems to have pretty good strength right now," Lynch says. "Remember, if you're a lender, you don't need a robust economy. You don't need the economy to be growing massively, you just need a steady, stable and growing environment."

Especially, we would add, for the lenders that know what they're doing.

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