GRANT'S
INTEREST RATE OBSERVER®

Vol. 30, No. 21b | Two Wall Street, New York, New York 10005 • www.grantspub.com | NOVEMBER 2, 2012

Reluctant optimist

The Bernanke Income Wilderness is not entirely barren even at zero percent interest rates. Here and there sprouts a desert flower, Golub Capital BDC (GBDC on the Nasdaq) among others. Golub lends at 10%, borrows at 3.6%, employs a little leverage and trades at a price to yield 8.04%. Skipping down to the bottom line, we are guardedly bullish on it. We would be unreservedly bullish if the price of its shares dropped below pro rata book value, instead of today's 9% premium to book.

"BDC," as noted in the prior issue of *Grant's*, means "business development company." BDCs lend to the kind of businesses that can't issue public equity or get the time of day from their Dodd-and-Franked bank. By law, BDCs are prohibited from borrowing more than a dollar against a dollar of equity, a stricture that has had the unintended consequence of driving some BDC managements to take more credit risk than they probably should. Choosing to be treated as regulated investment companies, the BDCs remit at least 90% of net income to their shareholders, on whom the resulting tax burden falls.

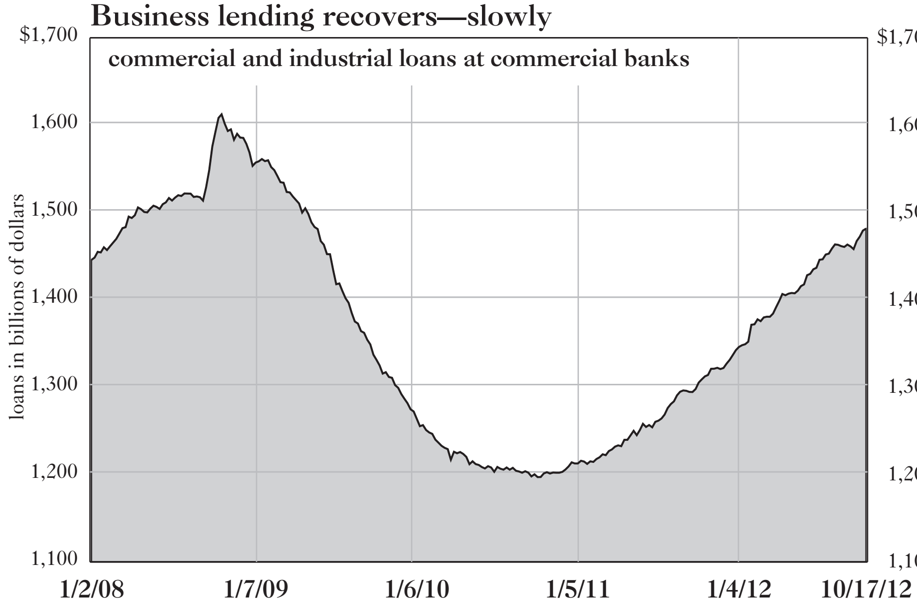
We should clarify something. Two weeks ago, *Grant's* said it was "bullish," not "guardedly bullish," on Ares Capital Corp., the biggest of the BDCs, even though Ares was quoted at 111% of book value. We have reconsidered how much better—how much safer and more remunerative—it is to invest at a discount to book rather than at a premium. Ergo, with regard to Ares, a correction: Toward it, too, we are only guardedly bullish, pending a lower Ares share price.

Fine for us to say, we realize, holding, as we do, a job. For those who live on their capital, we say that BDCs are among the best choices in a meager menu of income offerings. But you must not buy them if you require stability of principal. Only recall that the Ares share price plunged to $3.21 from $19.63 between the 2007 high to the 2009 low, even though Ares's credit results proved to be exemplary. Leveraged loan funds deliver less income than the BDCs, but they tend to be less volatile (see *Grant's*, Oct. 5).

Golub Capital BDC, with $711.5 million in assets as of June 30, is just 12% of the size of the $5.8 billion-asset Ares, but Golub has plenty to recommend it. Compared to Ares, for instance, Golub levies a lower management fee: 1 3/8% rather than 1 ½%. It has a higher hurdle rate on incentive compensation and subjects that compensation to a high-water mark, something Ares doesn't do.

"There are two elements of our fee structure that I think are important," David B. Golub, 49 years old, eponymous president of Golub Capital, which owns the business development company's external adviser, tells colleague Evan Lorenz. "One is that we have the lowest management fee out there. This is not because we are trying to be the K-Mart of our industry. This is because we couldn't understand why we should charge our public BDC investors higher fees than we charge our private investors. That difference alone versus, say, Apollo's BDC is about one point

Business lending recovers—slowly



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of investor yield. It's a lot. The second distinction is that when we went public, we structured our incentive fee so that it is capped at 20% of cumulative net income. We didn't do this because we wanted to be the cheapest guy in the industry. We did this because we thought it was fair. We looked at the then-existing fee structures and we thought they were not fair. `Heads I win, tails you lose,' doesn't seem to me to be the approach that a firm focused on long-term, win-win partnerships uses."

Golub's BDC went public less than three years ago, but Golub Capital has been lending to (and investing in) middle-market businesses since 1994. "They are one of the dominant players in the market," Greg Mason, managing director of specialty finance research at Stifel Nicolaus, advises Lorenz. (Stifel, let the record show, has done some investment banking for Golub.) "When you talk about who are the big players in the market . . . you've got GE Capital, Madison Capital, Oaktree, Ares and Golub."

While the Golub business development company arrived on the scene too late to prove its mettle in the 2007-09 credit tempest, Golub Capital Master Funding LLC, forebear to the BDC, began operations in July 2007. It produced no recorded impaired assets in either 2007 or 2008. Concerning fiscal years 2009, 2010 and 2011 (the fiscal year ends in September), nonaccrual loans net of writedowns totaled 2.23%, 0.9% and 0.63%, respectively, of overall loans, a sterling record indeed. As of June 30, nonaccruals net of writedowns amounted to 0.67% of the portfolio. "Their focus has always been on the conservative side. . . ," Mason says of Golub. "Their portfolio is one that generates a lower return and lower risk. They're not going to deliver you 10% to 11% dividend yields off of this portfolio, in our opinion. But, at the same time, it should hold up much better if we go into a recession. We call it a high-quality BDC—lower risk/lower return BDC. And I think that they get credit for that right now with the stock trading at 109% of book and a 8.04% yield, the market is recognizing and giving them credit, accepting a lower dividend yield than the BDC average because they recognize the higher quality of both management and the portfolio."

About 75% of the clients of Golub Capital BDC have been through a leveraged buyout. The typical borrower generates between $5 million to $50 million a year in earnings before interest, taxes, depreciation and amortization, and is the progeny of one of about 150 private-equity promoters with which Golub has developed a working relationship. "We're choosing the private-equity firms that pass our screens," Golub says. "These are firms that have good track records, that have stable managements, that are themselves very relationship-oriented, very partnership oriented. They're firms that have consistency of performance as one of their key attributes. And they're firms who, if they have a problem, are going to throw a lot of resources at fixing the problem, and are going to behave responsibly with their lender if they can't fix it. All of these attributes play a part in our underwriting strategy. Our underwriting strategy is to focus on transactions that have a low risk of credit loss."

At Golub Capital BDC, the *spécialité de la maison* is the senior mezzanine, or "unitranche" loan, a credit that combines a senior secured loan with a mezzanine, or junior, loan. For the borrower, such one-stop shopping saves in legal bills and negotiating hours while blending the cost of senior secured and junior unsecured financing. For the lender, the unification of junior and senior positions under one financial roof ensures that, in the event of a bankruptcy or workout, there need be no jockeying for position between the senior and junior creditors—after all, they're one and the same.

Golub is partial to the upper tier of the middle-market capital structure. As of June 30, the business development company's portfolio consisted of senior secured loans (41%), unitranche loans (37%), subordinated debt (12%) second lien loans (8%) and equity (3%). At 0.88 cents of leverage for every dollar of equity, GBDC is more highly encumbered than the average BDC, which shows leverage of 0.55-to-one. Then, again—more than compensating for that fact, we think—Golub's assets are safer than those of the average middle-market lender. Besides, as Golub points out, today's middle-market private equity sponsors, survivors of 2007-09, are putting up more equity than they have at least since the late '80s—42% or so nowadays vs. 20% or so way back then. The more equity beneath a lender, the lower the likelihood of default.

"People like to make our business complicated," Golub says, "It's not that complicated. The key to our business is being the guy who makes the fewest mistakes. You can make a little extra by taking on riskier loans. But, at the end of the day, if you look at who does well over a really extended period of time, the single most important driver is he who makes the least mistakes."

As for the timing of one's purchases of GBDC, the prudent investor could do worse than take a page from Golub himself, who tells Lorenz he likes to issue stock at a premium to book, repurchase it at a discount. More than likely—such are the volatile times in which we live—Mr. Market will oblige the value seeker with lower stock prices one of these days.

In discussions with Golub, Lorenz pointed out that GBDC raised $39.3 million in a secondary offering on Oct. 16. And in connection with that secondary, management disclosed that it had achieved middle-market originations in the sum of $113.4 million for the three months through Sept. 30; the previous quarter brought in just $25.6 million in middle market originations. Altogether, our reporter observed to Golub, you seem to believe that the world is good.

"I think you're right," the CEO replied, "that we are relatively optimistic. It's hard for me to say that because we are natural pessimists. For me to talk about optimism, I need to pinch myself while doing it. But we're relatively optimistic right now about the opportunity to continue to identify attractive loan assets in our market."

Give us a pessimistic credit man any day. But it does say something bullish about the so-called new normal that a decent number of midsize American businesses can afford to borrow at 10% and—more's the miracle—be expected to repay what they owe. Who knew?

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