

## **Is a Business Development Company the Right Source of Financing for Your Business or Transaction?**

### *Unlocking the Mystery of Business Development Companies*

Business Development Companies (BDCs) were created 35 years ago but are still unknown to some CFOs and retail investors. Little has been published or broadcast about their creation or purpose. This white paper offers insight on BDCs and how they provide an option as a financing source for middle market borrowers as well as an investment vehicle for retail investors.

The origin of the BDC can be traced to 1980 when it was created by Congress in an amendment to the existing Investment Company Act of 1940. At its core, a BDC is a company that provides capital and financing to businesses ranging from small to mid-sized, specifically companies with valuations ranging from \$10 million to \$500 million. In the United States, most BDCs are publicly traded companies and trade on an exchange in the same manner as other stocks.

BDCs are generally capitalized by a combination of publicly offered stock, loan facilities from large commercial banks, and, in many cases, debentures that are available to BDCs that are licensed as Small Business Investment Corporations (SBICs) by the Small Business Administration (SBA). This combination of often expensive funding (publicly offered stock with market-determined dividend yields of 7.5% to 13%), somewhat less expensive funding (bank loan facilities with interest rates of 4% to 8%) and very inexpensive funding (SBA debentures currently offered at 2.52%) produces a BDC's blended cost of capital. A 200% asset coverage rule requires that a BDC have at least \$2 of assets for every \$1 of outstanding debt. This rule effectively limits BDCs to a 1:1 ratio of debt to equity.

Like other capital providers, BDCs diversify their investments both geographically and across industries. The portfolios of the largest five BDCs in the U.S. cover on average 20 industries, representing regions across North America, South America and Europe. These investments take the form of a variety of financing vehicles, with first lien secured debt being the most common.

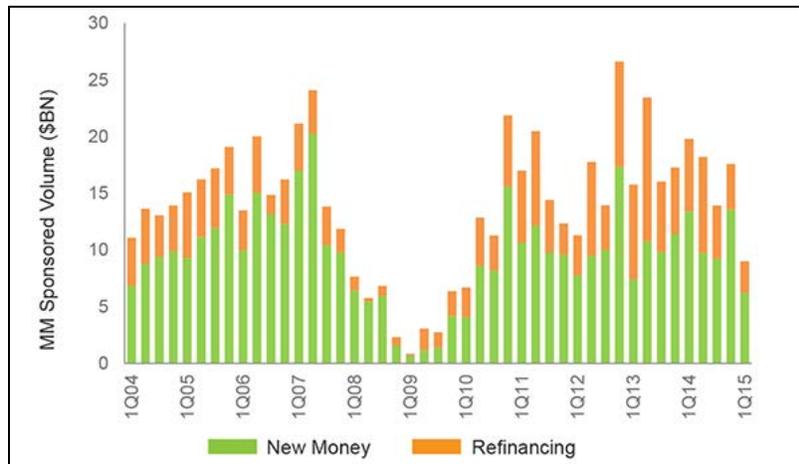
BDCs are closed-end investment companies, meaning that the number of shares of a BDC are fixed until its next secondary share issuance. BDCs are governed by an independent board of directors that is elected by its shareholders. BDCs essentially function as publicly traded funds that invest in private companies, and, in some cases, small illiquid public companies, with the goal of current income generation through interest earned and capital appreciation, when the BDC also holds an equity stake.

### ***BDCs as a Financing Source***

Mid-sized private companies, the major target for BDCs' investments, face a challenging and shifting market landscape. Evolving regulatory rules place an extra level of scrutiny on traditional bank lending that severely restricts the ability of commercial banks to lend to lower rated and unrated firms. Small and mid-sized companies, particularly those with low credit ratings, find themselves less attractive to banks than they were prior to the financial crisis. BDCs have stepped into this void, leveraging their unique debt-equity structure and a relative absence of regulation, to become a prominent lender to mid-sized and smaller-sized companies.

As evidenced in Figure 1 below, BDC lending to sponsored companies (*i.e.* those owned all or in part by a private equity sponsor) has experienced both expansion and contraction over the last ten years. However, lending activity has increased substantially over the past 5 to 7 years, in both number of deals and average transaction size. Private equity (PE) firms often turn to BDC financing to reduce the capital outlay required when a PE firm makes a new investment or when it seeks to recapitalize a portfolio company.

**Figure 1: Middle Market (MM) New Money vs. Refinancing Sponsored Volume**



Source: Thomson Reuters LPC; as of 3/31/15.

For CFOs, the most important difference between BDCs and commercial banks and mezzanine lenders is the broader array of financing packages that a BDC can offer a mid-sized business. BDCs offer senior and junior/mezzanine debt, on both a secured and unsecured basis. BDCs also offer what is referred to as “unitranche” financing, which is a “one-stop” offering that combines the capital available through a lower-yielding senior loan with the capital available through a higher-yielding loan (usually unsecured mezzanine or a junior debt facility). BDCs also offer equity investments, almost always paired with a debt facility. Adding an “equity kicker” can compensate a BDC for risks taken, in lieu of offering a debt-only facility at a higher interest rate.

For a summary comparison of financing sources see Figure 2 below. The broad offering of a BDC enables it to tailor a customized investment product to meet a company’s specific financing needs, while enabling the company to work with only one financing source, which, among other benefits, eliminates the often tedious, time consuming and costly process of negotiating inter-creditor agreements. This single-source financing can also streamline the closing process and simplify post-closing reporting.

**Figure 2: Comparison of Financing Sources**

Lending Organization	Senior Debt	Junior / Mezzanine Debt	Unitranche Debt	Equity Investment
<b>Business Development Companies</b>	✓	✓	✓	✓
<b>Commercial Banks</b>	✓			
<b>Mezzanine Firms</b>		✓		✓
<b>Specialty Finance Companies</b>	✓			✓

### *Investment in BDCs*

For investors, BDCs are an alternative to PE, mezzanine firms and venture capital (VC) firms. All of these firms provide closed-end investment vehicles that invest in portfolio companies, with their success dependent on choosing wise investments. However, there are important differences. PE firms, mezzanine firms and VC firms are all private organizations. Such investment vehicles are not available to unaccredited investors or the general public. BDCs are the opposite; most are publicly traded with easy entry and exit for the retail investor. Another noteworthy difference between BDCs and PE firms, mezzanine firms and VC firms is that BDCs do not open and close funds based on a predetermined investment horizon. These other funds “close” when the desired funding level is reached and generally do not return any capital until at or near the end of the investment cycle, usually 4 to 7 years. BDC firms do not follow such a cycle. Their goal is a perpetual existence, with the ability to return to the capital markets to raise investable funds whenever necessary, regardless of when their investments are liquidated. As such, the corporate life of a BDC is potentially infinite, and a BDC’s performance can be measured over a much longer time horizon.

As most BDCs are public companies, information on their stock performance is available in real time. BDC share prices are, generally speaking, the market’s reaction to (i) a BDC’s dividend level, which is typically set in advance by its board, and (ii) its net asset value (NAV), which is announced along with a BDC’s quarterly earnings. A BDC that is viewed by the market to have low risk (*i.e.* a sustainable dividend and a portfolio with a high credit quality) and/or high growth prospects will generally trade at a lower dividend yield and a higher price-to-NAV, compared to its peers. A recent survey of stock market data shows current BDC dividend yields ranging from ~7.5% to ~13.0% and current BDC price-to-NAV ratios ranging from ~0.68 to ~1.40.

BDCs receive different legal treatment than PE firms, mezzanine firms and VC firms, including with respect to their taxation. Nearly all BDCs maintain the status of regulated investment companies (RICs). They are required to maintain 70% of their investments in eligible assets. Eligible assets include investments in any domestic issuer that is not listed on a national exchange, or, if listed, has a market capitalization of under \$250 million. As an RIC, a BDC’s earnings are not taxable at the company level, but its dividend distributions are taxable to its shareholders at regular individual income tax rates. An RIC is required to distribute 90% of its investment company taxable income to shareholders each year. This distribution requirement is similar to that of a real estate investment trust (REIT).

According to Closed-End Fund Advisors (CEFA), there were 51 BDC closed-end funds as of October 17, 2014. These 51 funds represent a combined market cap of \$35 billion, versus the \$263 billion market cap of traditional closed-end funds. Some examples of the largest and most well-known BDCs are Ares Capital Corporation, American Capital, Ltd., Prospect Capital Corporation, Apollo Investment Corporation and Main Street Capital Corporation. These five BDCs represent almost \$16 billion in market capitalization and have all been publicly traded since 2007. Competition among BDCs has become significant.

### ***Concluding Thoughts***

BDCs meet the distinct and underserved financing needs of private middle-market companies across diverse industries. Their characteristics can make them longer-term, patient lenders with permanent capital available. BDCs provide more flexible and creative structures that distinguish them from other lenders, and they will often lend more against a company's assets and cash flows than will their competitors. However, BDCs are generally a more expensive form of financing and there is some uncertainty inherent in relying on a lender that is subject to the whims of the public markets. For retail investors, BDCs are available to those who cannot afford the minimum amount required to participate in a PE, mezzanine or VC fund.

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### **HighBank Advisors LLC**

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