

# COVER STORY

## BDCs Emerge As Middleweight Contenders

By Steve Bills

Since the end of the financial crisis in 2009, the leveraged finance business has undergone a significant realignment.

**B**anks, under pressure from Dodd-Frank financial reforms and stepped-up regulatory oversight, have retreated from making risky cash-flow loans. Credit hedge funds, burned in the downturn by investor redemptions, have turned their attention away from illiquid mid-market loans to favor more tradeable broadly syndicated loan participations. CLOs, which rebounded strongly in 2012, have shifted the bulk of their portfolios away from risky 'CCC' tranches and toward higher-rated credits.

Stepping in to fill the void are business development companies, or BDCs, mid-market lenders that have blossomed in the new environment.

"A lot of participants in the market prior to the crisis have pulled back dramatically, or in the case of the banks, cannot be as aggressive as they once were," said **Greg Mason**, an analyst at Stifel Nicolaus & Co. Inc. in St. Louis. "Since 2010, the BDC space has been on a significant growth trajectory."

For one thing, the number of competitors in the market has boomed. Since 2010, at least 17 new BDCs have gone public, nearly doubling the number of providers in the market. And they are raising more capital: \$3.6 billion in follow-on financing in 2012 alone, according to Stifel Nicolaus, the second-biggest year for such fundraising, behind only 2007, the last year of the mid-decade deal boom before recession and financial crisis set in (see chart, p. 33).

BDCs are not for everybody. Historically providers of mezzanine financing for leveraged buyouts, the companies typically lend to businesses with annual revenue of less than \$500 million, making them squarely mid-market lenders. Still, market watchers



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—Theodore L. Koenig, president and chief executive officer of Monroe Capital

say, the primary use of BDC capital is financing LBOs.

In most cases, the new BDCs are not new players in the market. Monroe Capital Corp., for instance, one of five new BDCs to go public in 2012, is an affiliate of the Chicago specialty finance company Monroe Capital LLC, a longtime lender for LBOs. TCP Capital Corp., another new entrant, is affiliated with the hedge fund Tennenbaum Capital Partners LLC, of Santa Monica, Calif., best known as an investor in distress. Orchard First Source Capital Inc. of Rolling Meadows, Ill., obtained a BDC license after deciding that a CLO structure, which it had considered, was too complicated in the wake of the financial crisis. Stellus Capital is a spin-out of the direct capital unit of the multi-strategy D. E. Shaw group. WhiteHorse Finance is affiliated with **H.I.G. Capital LLC**.

Much the same has been true in the previous two years, when new BDC launches were affiliates of private equity firms such as **New Mountain Capital** and **Thomas H. Lee**

**Partners LP**, non-BDC lenders such as Golub Capital Inc. or additional offerings by existing BDCs such as Solar Capital Ltd and PennantPark Investment Corp. Solar Capital, for instance, launched its follow-on Solar Senior Capital Ltd to take advantage of investments higher up the capital stack than its main business pursues.

### New Requirements

"You can no longer do a BDC that's a blind pool. You have to have a portfolio of assets to roll into the BDC so people can see what they're buying," Mason said. "Only existing players can start a BDC."

That was explicitly the approach taken by Monroe Capital, which launched its \$75 million BDC in October, capitalizing it initially with a portfolio of loans from its other lending operations, then using the proceeds from its IPO to repay the parent company. Monroe Capital promptly turned around to expand its own syndicated credit line, led by ING Capital LLC, by \$30 million to \$55 million, and with four new lenders joining the facili-

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ty.

But other BDCs, observing what happened during the financial crisis when bankers pulled back on their financing commitments, have begun to turn to other forms of credit financing. (Unlike commercial banks, which can lever their portfolios more than 10x based on their capital reserves, BDCs are limited by federal law to a 1:1 leverage ratio against their assets.)

Prospect Capital Corp., for instance, floated \$200 million of senior unsecured convertible notes in December, which come due in 2019, while PennantPark floated \$67.5 million of senior unsecured retail notes in January. Those notes, PennantPark's first such issue, mature in February 2025. Such moves can provide a more stable source of financing for BDC lending, while at the same time providing some protection to the companies' investors against the risk of rising interest rates.

In addition, a new category of competitor began to emerge in 2012—non-traded

BDCs, which have attracted the backing of big buyout shops including **Apollo Global Management**, **Kohlberg Dravis Roberts & Co.** and **Blackstone GSO Capital Partners**. While those BDCs operate under the same Small Business Investment Incentive Act of 1980 that set up other BDCs as REIT-like pass-through investment vehicles, the non-traded variants do not initially list their shares on public exchanges, essentially locking in their equity investors for long-term hold periods.

Although such arrangements would seem to handcuff public investors, for whom the liquidity to buy and sell shares is a major attraction, from the standpoint of a financial sponsor seeking to finance a portfolio company, non-traded BDC money is the same shade of green. BDCs can lend only to U.S.-based companies not listed on a stock exchange, typically with annual revenue of less than \$500 million and assets of less than \$4 million, among other limitations.

With so many players crowding into the market, the participants can only hope that the business comes along. "Last year a lot of the PE sponsors decided to take dividends," said **Theodore L. Koenig**, the president and chief executive officer of Monroe Capital.

Those sponsors were motivated by strengthening portfolio company balance sheets and the availability of inexpensive credit. Looking ahead to 2013, lenders are hoping for a revival in M&A to drive demand.

In the meantime, observers expect BDCs to remain popular. With plans for yields of 9 percent or better, the vehicles provide one of the few investments where investors can achieve high single-digit or low double-digit returns in today's low-interest rate environment. Indeed, 2012 was the No. 2 year for BDC equity fundraising, behind only 2007, said Mason of Stifel Nicolaus. "I would not be surprised if 2013 exceeded that 2012 number." ♦

### Raising BDC Capital

2012 was the second largest year for business development company fundraising, trailing only 2007

