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Higher Leverage for BDC's

(companies mentioned- MAIN, ARCC, FSIC, PSEC, AINV)

Last week's Omnibus budget deal changed the basic rules for BDC's (Business Development Companies) allowing them to boost their leverage ratio from a maximum 1:1 Debt/Equity to 2:1. The new bill also allows BDCs with Asset/Debt Ratios as low as 150% to declare dividends, down from the previous level of 200%. These changes have been proposed for years and often enjoyed bi-partisan support.

Business Development Companies focus on providing funding to small businesses. They operate with characteristics similar to REITs and closed-end funds in that they can avoid paying income taxes if they **distribute at least 90% of taxable income to shareholders**. They can also avoid a 4% federal excise tax by distributing 98% of ordinary income and 98% of capital gain income to shareholders. **At least 90% of income must come from dividends, interest income, and capital gains on the sale of securities. The biggest difference for a BDC is it is not passive**. It is expected to provide "significant managerial assistance" to companies it invests in. Like a closed-end fund, a **BDC charges a fee based on assets under management.**

The primary rationale for setting up BDCs was to provide capital to small US companies and some managerial experience to help them grow. Thus, **a minimum of 70% of BDC assets must be invested in US companies that are private or have a market cap under $250 million if they have public securities**. In many cases, these companies have a difficult time obtaining capital through traditional banking avenues. **The private status for some companies allows BDCs to invest in companies that would be larger than $250 million if they were public.** Many LBOs (Leveraged Buy-Outs) fit this bill and BDCs lend money in that area.

From an investor's point of view, BDCs offer exposure to largely small private businesses where growth may be faster, yet due to diversification rules, investors can gain exposure to a basket of these companies instead of investing privately in one or two. Also, BDC tax rules tend to result in most BDCs paying significant dividends, so these are often viewed as income substitutes for bonds, REITs and other traditional income investments.

There are some pluses and minuses to these companies, and we will illustrate some of them by looking at a few of the larger ones. FYI – there are several BDCs that are essentially small cap stocks themselves. Only five are consistently well over $1 billion in market cap size. Also, many of the BDCs are less than 10-years old, which means they have yet to go through tough times.

The dividend yield is attractive. The yields tend to be in the 9%-11% range for many in the universe. The high dividend limits growth both in the business and the dividend:

1. Paying out more than 90% (and in many cases over 98%) of income, it is difficult to grow the portfolio and income without raising more capital. But, that new capital is expensive at 9%-11% dividend yields.

2. BDCs are limited in how much they can borrow. The hard cap is rising from 1:1 debt to equity to 2:1 now. That can allow more loans to be made initially, but eventually the BDC moves to the same situation with higher leverage. It would need to raise more equity capital to grow.

3. As we will discuss below, because there is not much if any dividend growth and the dividend payout is very high, BDCs are interest rate sensitive and often trade below book value. In many cases, they cannot issue new equity below book value without shareholder approval – that also means it is difficult to raise new capital.

Ares Capital (ARCC) points this out in its 10-K, "Equity capital may be difficult to raise during periods of adverse or volatile market conditions because subject to some limited exceptions, as a BDC, we are generally not able to issue shares of our common stock at a price less than the net asset value without first obtaining approval for such issuance from our stockholders and our independent directors."

In looking at four of the largest BDC's, all but MAIN (Mainstreet Capital) trade at a discount. Of the full universe, only a couple of others are at or above book value and the largest ARCC (Ares Capital Corp) is at about 5% discount. So, this group has a tough time raising capital and without that ability, it is difficult to grow the company or the dividend. Also, dividend yields are high, but do not really grow:

		Y/Y Dividend Growth Rate				
Ticker	Yield	2014	2015	2016	2017	2018 ytd
ARCC	9.6%	0%	0%	0%	-3%	0%
FSIC	10.6%	22%	-12%	0%	0%	-15%
MAIN	7.6%	-4%	4%	3%	2%	3%
PSEC	10.7%	1%	-13%	-5%	0%	-28%

- This includes special dividends. Arguably, neither ARCC nor MAIN has cut regular dividends only special dividends
- MAIN has a 25% equity portion of the portfolio which differentiates it more

Boosting leverage is unlikely to happen in days, but assuming more debt is used, the income level should increase. That, in turn, means the dividends could also rise to a higher level, but would then level off. So, perhaps in 2018 and even 2019, the sector should see some dividend growth and thus capital appreciation. Two things will offset that – management fees and few are going to boost leverage to 200% of equity.

Fees are calculated on assets under management not capital. Boosting leverage will increase the asset total and with most of the BDCs still trading below book value, they are unlikely to issue much new capital. Some selling at a big discount may be more likely to repurchase shares and boost leverage without growing the portfolio.

Fees normally run about 1.5%-2.5% of assets as a minimum fee. Incentive fees have high water marks to reach and are capped at 20% of gains. Incentive fees can add 0%-3% in most years – but there are years when it may higher. So, if we look at a very simple example of a BDC currently at 80% leverage making 8% on loans that boosts its leverage to 120%, income should rise – but not as much as many initially believe:

	Current Situation	New Situation
Assets	$180	$220
Debt	$80	$120
Equity	$100	$100
Interest Income	$14.40	$17.60
Interest Expense 2%	$1.60	$2.40
Net Interest	$12.80	$15.20
Mgt Fees 3%	$5.40	$6.60
Other costs 1%	$1.80	$2.20
Net Income	$5.60	$6.40

In this case, assuming interest earned and paid hold at the same rates, Net Interest Income rises by 19%. However, the rise in management fees and other fees offsets some of that growth and the income going to shareholders rises only 14% on a 50% increase in borrowing.

The leverage ratio of 200% is a hard cap. BDCs can start running into trouble if they are near the cap and have some portfolio investments become impaired and need to be marked to a lower valuation. When that happens, the leverage ratio rises. If it approaches the cap, the BDC either needs to sell assets to pay down debt or raise more capital. We've already addressed that it is difficult to sell more shares, especially if they are doing it to avoid breaking their leverage cap. The Asset/Debt ratio also comes into play as Assets are impaired. It must remain above 150% or the BDC cannot pay dividends. Therefore, few of these companies look to approach the edge of the hard cap. In fact, a company that is paying its dividend with plenty of room to grow its leverage a bit more should be more desirable, in our opinion.

	ARCC	FSIC	MAIN	PSEC
4Q Leverage Ratios	0.66	0.75	0.55	0.63

We should note that ARCC and FSIC have been fairly consistent of late at those levels. However, MAIN is often over 0.66 and PSEC has been above 0.7 also. Increasing the leverage cap to 200% from 100% would boost earnings and dividends. A **fear that these companies will completely go insane and push the edge of leverage to 190% does not seem warranted to us. So, higher leverage should drive some earnings and dividends. Risk levels will rise at some in the industry, but even that will take some time to reach much higher borrowing levels.**

One thing that could mitigate the higher earnings would be if the BDCs see yields decline as the whole industry looks to put much more money to work and that competition hurts the spread they lend on. In our simple example above, we assumed a 6% spread (8% interest earned against 2% borrowing costs.) If the spread shrinks to 5% or 4%, increasing the leverage ratio may only work to hold interest income flat or up slightly. However, remember the fees will rise with assets and hurt income to investors. Moreover, there are some companies, who are probably looking for new capital to grow, but are unwilling to pay 8%-10% and may not be very leveraged. That could become a new market also where that company pays a lower rate and also pressures income growth created from the higher leverage ratio.

We are also curious to see if more of this leverage goes to support a great percentage of equity investing. That would make returns lumpier and probably result in more special dividends. However, total returns could be greater. Mainstreet is already doing more of this and that is one reason its dividend growth has held up and the stock trades at a premium. Ares bought another BDC several quarters back that had a lower yielding portfolio and it has been transitioning much of it into Ares lending models. It has been seeing gains on several investments that have been realized.

Another aspect to watch is where BDCs deploy their 30% non-conforming bucket of assets. That pool can also get larger. As noted above, they must have at least 70% in US companies, and those companies must either be privately-owed or have market caps under $250 million. With the new law only a week old, there is not much news on where these non-conforming assets may go.

What about interest rates? There are several levels of interest rate risk in the BDCs.

1. The companies have a difficult time growing the dividends without raising capital as noted above. The higher leverage ratio should allow some dividend growth in the next two years, but then they may flatten out again. That would make these stocks essentially a bond with no maturity and higher interest rates tend to pressure prices of those types of stock - **So a problem with a potential 2-year reprieve, it may be a potential positive now.**

2. Within the portfolios, many of these companies are actually set up to benefit from higher interest rates. They have a large portion of their debt fixed rates while their portfolio is largely floating rates. Not all of them give this information in a detailed manner, so FSIC noted that 69% of its portfolio is floating rate and 37% of its own debt is floating. ARCC and MAIN are in better shape and provide more detail:

	% Portfolio Floating	% Co. Debt Floating	Annual EPS change from LIBOR change: 100bp	200bp	300bp
ARCC	90%	13%	$0.17	$0.34	$0.51
MAIN	72%	8%	$0.19	$0.37	$0.56

Again, ARCC has more debt investments and MAIN has more equity, so this impacts these figures on the portfolio side. But, both have locked in lower funding costs for the bulk of their financing and should benefit on the earnings side even before higher leverage. ARCC is paying $0.38 per quarter in dividends; a 200bp change in Libor is almost a 5th dividend. **This is a net positive**.

3. **Companies within the portfolio would need to pay the higher interest rates. That can have a negative impact on the valuations of investments.** Again, data is mixed. ARCC reports that companies it lends money to are seeing accelerating EBITDA growth of 6% in 4Q17, 4% EBITDA growth in 3Q17, and the average company's total debt is about 5.4x EBITDA. FSIC only reports that debt to EBITDA is about 4.9x within its portfolio investments. MAIN reports that its smallest group of companies LMM (Lower middle market) is leveraged about 3.3x EBITDA. It is our belief that if interest rates rise slowly, this may be offset in the short-term by the rising cash flow the investments are throwing off to the BDC, essentially, discounting a rising cash flow stream at a slightly higher hurdle rate. **We will call this neutral to negative**.

4. The BDCs value their investments with 3rd party appraisals, public valuations of similar investments, and historical experience. One thing that can play a role in that is the spread of high-yield bonds to treasuries, basically, the risk premium for leveraged loans. Currently, the spread is about 360bp. Historically, there are often spikes of up to 800bp even when there is not full-scale panic like 2008-09. So, a spread of 500bp would not be unreasonable at times. The St. Louis Fed reports this ratio and this link will show you the historical chart. This pressure is building in our view with higher rates because that may also extend the exit strategy of some private or small companies who are likely to be acquired. The cost to finance a new purchase would increase if this spread widens. We think this is a significant risk with the spread below 500bp. The one ray of light is their debt-to-equity ratios are in the 60%-70% range and the cap is 200% now. Even if the value of the portfolio was dramatically cut, it would likely still be paying and the BDC would not need to sell the investment or raise capital to risk running afoul of the new rules. **We would characterize this as a major risk for a BDC that tops 160% debt-to-equity or has a history of operating very close to the recent 100% hard cap**. The new rules also relax the Asset-to-Debt ratio from 200% to 150%. This is key because, the BDC CANNOT pay dividends if it breaks this test. We are more than comfortable forecasting that a BDC bought for a 10% yield that now pays zero – would see a much lower valuation.

5. Poor liquidity. This may not be as much an interest rate problem as an overall market sentiment problem. There are several dozen BDCs and most have a market cap of only $100-$500 million. This can be something people chase for yield and then turn cold on. Moreover, if one or two have problems, people can turn on the whole sector. So, for having very high yields to buffer the stock price, there are still some sizeable moves in prices here. We attribute some of that to macro interest rate investing – rising rates is bad for yield companies and falling rates helps yield companies.

Conclusions:

The new rules allowing BDCs to boost leverage and operate with lower asset to debt ratios has the ability to let some of these companies dig a deeper hole and others to grow their dividends. In both situations, the operators of the BDCs will earn higher fees. In the case of the dividend growth, this may be a 1-2 year period of reasonable growth and that could offset some of the interest rate fears. The portfolios themselves are showing rising cash flows simply from increases in rates and these stocks have not been rewarded for that.

We would be reluctant to pay a significant premium for any BDC and we would avoid BDCs that have a difficult time sustaining their dividends. AINV (Apollo Investment Corp.) comes to mind as it has dropped its dividend from $0.52 per quarter to $0.15 over the last 10-years. We would also tread lightly on those with debt-to-equity ratios greater than 85% prior to the rules changes and those that were formed in 2012 and later. They would have had a tailwind of a shrinking premium for junk debt and lower interest rates for their existence.

We do believe ARCC offers some value with a lower portfolio leverage that can rise a bit even without the new rules. It is also transitioning away from some 0%-very low yielding investments into new deals that even if they are priced at a lower spread than ARCC's traditional book – would likely still grow the income without adding leverage. It is the largest stock in the group, trading at a discount. Basically, it appears to offer several additional tailwinds compared to others in this group along with the new rules to counter the various interest rate fears.

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