New Law Could Spur the Next Wave of BDC Capital Raising

The Small Business Credit Availability Act is poised to reverse the multiyear downward trend in issuance activity by BDCs. It could also free up more capital to be put to work in the already competitive middle-market lending landscape.

Industry Commentary

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On March 23, 2018, President Donald Trump signed into law the Small Business Credit Availability Act (SBCAA), which aims to increase lending to small- and medium-size businesses by increasing the leverage limits on business development companies (BDCs) and streamlining their SEC reporting requirements. For capital-starved BDCs that have been unable to raise equity capital because they are trading below their book value, the new law provides access to new sources of capital and should spur increased lending to U.S. businesses.

We examine the impact that the SBCAA could have on debt issuances, and eventually equity issuances, by BDCs. We also look at the potential positive and negative effects that the new law could have on returns that BDCs generate for their investors.

Overview of BDCs and the Small Business Credit Availability Act
BDCs, which are regulated under the Investment Company Act of 1940, are closed-end funds that must invest a majority of their capital in small and developing U.S. companies. But unlike venture capital or private equity funds, BDCs can receive investments from nonaccredited investors.

Although Congress created BDCs as an investment vehicle in 1980, they did not gain prevalence until the past decade. As banks pulled back on their lending to small- and medium-size businesses in response to the credit crisis and the ensuing tighter regulatory oversight ushered in by the Dodd-Frank Act, BDCs gained traction in filling this void.

Throughout their history, BDCs' borrowing had been limited by having to maintain an asset-to-debt coverage ratio of at least 200%. In most cases, this generally translated to a maximum debt-to-equity ratio of 1.0x. The SBCAA, however, loosens the borrowing limits placed on BDCs by lowering the minimum asset coverage to 150%, or a debt-to-equity ratio of 2.0x.

There are two ways BDCs can get approval to access the higher leverage levels:

- **Board approval:** The simpler option involves getting approval from the BDC's board of directors; this method also requires the BDC to wait at least one year after getting approval before increasing leverage.

- **Shareholder approval:** The more labor-intensive option involves getting shareholder approval; this method allows BDCs to increase leverage on the day following getting shareholder approval.

Regardless of which method is used, BDCs with secured debt would need to renegotiate terms with their lenders before increasing their leverage levels.

Impact on BDC Capital Raising and Returns

We expect nearly all BDCs to take advantage of the "free option" granted by the SBCAA and seek approval to increase their leverage levels. We also believe that the vast majority of BDCs will take the simpler, cheaper route by getting board approval. Getting shareholder approval could be a cumbersome, expensive process because most BDC shares are owned by retail investors. There should be an increase in capital-raising by BDCs over the next several years—although the full effect will not be seen until mid-2019 at the earliest because of the 12-month waiting period for companies that get board approval rather than shareholder approval.

As evidenced by the decline in the number of equity and debt offerings by BDCs since 2012, many of these funds have become increasingly capital starved over the last several years. The number of IPOs and follow-on offerings by BDCs surged to a high of 39 in 2012—as BDCs rushed to access public capital so they could capitalize on the lending void left by banks. But the number of equity offerings has plummeted in recent years. Since the beginning of 2015, there has been a total of only 45 BDC equity offerings. This is because many BDCs' shares have been trading below book value, shutting these funds out from issuing new equity without shareholder approval.

On the debt side, activity peaked in 2013, and there has since been a similar decline in issuances because most BDCs had hit or neared the former leverage limits. Last year saw a modest uptick in debt issuances, but this was largely a function of BDCs taking advantage of 2017's historically low risk-free rates and junk bond spreads to refinance high-coupon debt that had been issued circa 2013 and had reached the end of its three-year noncall period. Last year's issuance uptick often involved hybrid capital, such as preferred stock or baby bonds.

Now that the leverage limits have loosened, we expect BDCs to begin accessing this capital while rates

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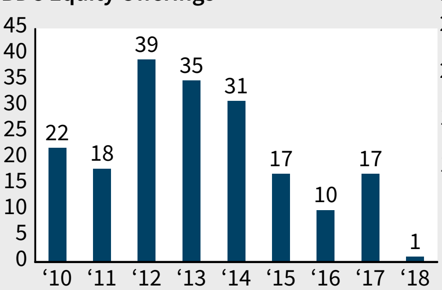
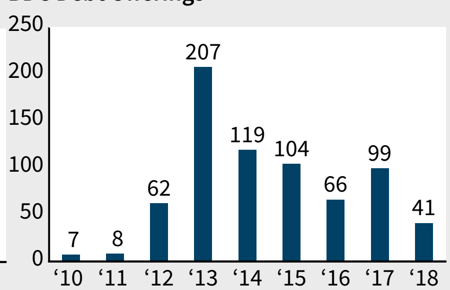
Reversing the Downward Trend?

By loosening leverage limits for BDCs, the Small Business Credit Availability Act should lead to an uptick in debt offerings. BDCs that are able to successfully deploy that debt capital may eventually look to access public equity markets once their share prices exceed book value.

BDC Equity Offerings



BDC Debt Offerings



Source: S&P Global Market Intelligence as of April 25, 2018 are still low. Assuming they can find investment opportunities that exceed their cost of capital, which in today's environment would likely be around 6.5%, BDCs would be able to enhance the value of their common stock. If they can boost their share prices above book value, BDCs will then be free to raise more equity capital.

While this positive feedback loop is certainly feasible, there is also a potential negative effect of the looser leverage limits. By freeing up additional capital to be deployed in what is already a hyper-competitive middle-market lending environment, spreads could be pushed lower. This would be a drag on BDCs' dividend yields, which today typically range between 8% and 12%.

Another potential result of the looser leverage limits is that even if BDCs cannot find investment opportunities that are expected to generate returns in excess of their borrowing costs, BDCs may still elect to increase their leverage and use the proceeds to buy back stock. If the stock is trading at a significant discount to book value, this approach could be an effective way to return value to shareholders.

The looser leverage limits also leave BDCs with strategic decisions regarding the credit quality and risk profile of their portfolios. BDCs could look to improve the credit quality of their books by making more senior, lower-yielding loans, driving similar returns through the use of the looser leverage limits. Alternatively, BDCs could continue with their current risk profile and potentially generate higher returns by increasing leverage, assuming no significant change in spreads. The higher returns should lead to higher valuations and, ultimately, allow BDCs to execute equity raises that are accretive to book value and earnings.

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Recent Baby Bond Offerings

Amount	Issuer	Offering	Date
$46,000,000	CAI	Preferred Stock	March 2018
$70,000,000	B RILEY	Senior Notes	December 2017
$100,000,000	MVC CAPITAL	Fixed Rate Notes	November 2017
$80,000,000	seaspan	Senior Notes	October 2017
$32,500,000	Horizon Technology Finance	6.25% Notes due 2022	September 2017
$17,830,175	KCAP FINANCIAL, INC.	Bond Offering	September 2017
$28,375,000	GREAT ELM CAPITAL	Bond Offering	September 2017
$250,000,000	enovafinancial	Senior Notes	September 2017
$70,000,000	Capitala	Senior Unsecured Notes	May 2017

BDC Hybrid Capital Issuances

In 2017, there was an uptick in BDC debt offerings, many of which involved hybrid capital, such as preferred stock and baby bonds. Many BDCs looked to take advantage of 2017's historically low interest rates to refinance debt issued in 2013 or 2014.

Comparable Trading Analysis: BDC Baby Bonds & Preferred Stock
($ and trading volume in millions, excluding per share amounts)

Offering Date	Issuer	Exchange:Ticker	Trans. Value[1]	Offering Price	Current Price	Current/ Offering	Yield	Coupon	Price/ Book	3 Mo. ADTV	Market Cap.	Term	Maturity	Dist. to Date
2/15/18	Newtek Business Services Corp.	NasdaqGM:NEWTI	$50,000.0	$25.00	$24.42	102.2%	6.80%	6.25%	1.179	0.108	$329.0	5 Yrs	3/1/23	Qtrly
1/30/18	Fidus Investment Corporation	NasdaqGS:FDUSL	43,478.0	25.00	25.50	102.0%	5.42%	5.88%	0.797	0.122	316.8	5 Yrs	2/1/23	Qtrly
1/11/18	Great Elm Capital Corp.	NasdaqGM:GECCM	43,000.0	25.00	24.40	97.6%	7.19%	6.75%	0.745	0.013	98.5	7 Yrs	1/31/25	Qtrly
12/12/17	Capital Southwest Corporation	NasdaqGS:CSWCL	50,000.0	25.00	25.48	101.9%	5.41%	5.95%	0.921	0.019	275.0	5 Yrs	12/15/22	Qtrly
11/8/17	MVC Capital, Inc.	NYSE:MVCD	100,000.0	25.00	25.45	101.8%	5.74%	6.25%	0.738	0.042	186.3	5 Yrs	11/30/22	Qtrly
9/26/17	Horizon Technology Finance Corporation	NYSE:HTFA	32,500.0	25.00	25.59	102.4%	5.59%	6.25%	0.878	0.075	117.9	5 Yrs	9/15/22	Qtrly
9/19/17	Gladstone Capital Corporation	NasdaqGS:GLADN	45,000.0	25.00	25.04	100.2%	5.97%	6.00%	0.992	0.127	229.3	7 Yrs	9/30/24	Monthly
9/18/17	KCAP Financial, Inc.[2]	NasdaqGS:KCAPL	17,830.0	25.00	25.40	101.6%	5.68%	6.13%	0.650	0.094	116.7	5 Yrs	9/30/22	Qtrly
9/13/17	Great Elm Capital Corp.	NasdaqGM:GECCL	28,375.0	25.00	25.40	101.6%	6.05%	6.50%	0.745	0.013	98.5	5 Yrs	9/18/22	Qtrly
8/21/17	Harvest Capital Credit Corporation	NasdaqGM:HCAPZ	25,000.0	25.00	25.58	102.3%	5.48%	6.13%	0.815	0.023	65.9	5 Yrs	9/15/22	Qtrly
8/16/17	Stellus Capital Investment Corporation	NYSE:SCA	42,500.0	25.00	25.31	101.2%	5.40%	5.75%	0.919	0.096	202.5	5 Yrs	9/15/22	Qtrly
7/11/17	TriplePoint Venture Growth BDC Corp.	NYSE:TPVY	65,000.0	25.00	25.29	101.1%	5.43%	5.75%	0.901	0.089	213.1	5 Yrs	7/15/22	Qtrly
5/23/17	Capitala Finance Corp.	NasdaqCM:CPTAG	50,000.0	25.00	24.66	98.6%	6.14%	5.75%	0.572	0.083	126.9	5 Yrs	5/31/22	Qtrly
5/10/17	Capitala Finance Corp.	NasdaqGS:CPTAL	70,000.0	25.00	25.15	100.6%	5.83%	6.00%	0.572	0.083	126.9	5 Yrs	5/31/22	Qtrly
4/4/17	Oxford Square Capital Corp.	NasdaqGS:OXSQL	57,500.0	25.00	25.52	102.1%	6.08%	6.50%	0.799	0.223	306.6	7 Yrs	3/30/24	Qtrly
12/13/16	Saratoga Investment Corp.	NYSE:SAB	65,000.0	25.00	25.61	102.4%	6.18%	6.75%	0.903	0.016	127.5	7 Yrs	12/30/23	Qtrly
11/16/16	THL Credit, Inc.	NYSE:TCRZ	22,000.0	25.00	25.71	102.8%	5.95%	6.75%	0.750	0.150	255.8	6 Yrs	12/30/22	Qtrly
9/19/16	Gladstone Investment Corporation	NasdaqGS:GAINM	50,000.0	25.00	25.19	100.8%	6.07%	6.25%	1.052	0.209	354.9	7 Yrs	9/30/23	Monthly
6/23/16	Hercules Capital, Inc.[3]	NYSE:HTGX	60,000.0	25.00	25.04	100.2%	6.22%	6.25%	1.238	0.384	1,026.1	8 Yrs	7/30/24	Qtrly
		Mean	$48,272.8	$25.00	$25.25	101.2%	5.93%	6.20%	0.851	0.104	$240.8	6 Yrs	4/15/23	
		Median	50,000.0	25.00	25.40	101.6%	5.95%	6.25%	0.815	0.089	202.5	5 Yrs	12/15/22	

Data as of April 25, 2018.
(1): Excludes over-allotment.
(2): Two issuance of Bonds; first on August 14, 2017 and second on September 18, 2017, raising $50 million and $18 million, respectively.
(3): Two issuance of Bonds; first on April 20, 2016 and second on June 23, 2016, raising $65 million and $60 million, respectively.

BDC Equity Offerings

After peaking in 2012, public equity raising by BDCs has slowed significantly as many BDCs' share prices have fallen below book value.

Comparable Trading Analysis: BDC Equity Offerings

($ and trading volume in millions, excluding per share amounts)

Offering Date	Issuer	Exchange:Ticker	Trans. Value[1]	Offering Price	Current Price	Current/ Offering	Yield	Coupon	Price/ Book	3 Mo. ADTV	Market Cap.	Term
3/20/18	TPG Specialty Lending, Inc.	NYSE:TSLX	$65,438.0	$17.45	$17.80	0.3%	2.1%	2.0%	1.094	0.352	$1,151.2	7.88%
10/25/17	PennantPark Floating Rate Capital Ltd.	NasdaqGS:PFLT	84,900.0	14.15	13.23	(2.4%)	0.0%	(6.5%)	0.954	0.256	513.0	8.08%
6/27/17	WhiteHorse Finance, Inc.	NasdaqGS:WHF	30,734.0	13.97	12.96	(4.8%)	(4.8%)	(7.2%)	0.927	0.054	266.1	10.29%
6/20/17	Fidus Investment Corporation	NasdaqGS:FDUS	29,400.0	16.80	12.95	(1.0%)	0.4%	(22.9%)	0.797	0.122	316.8	8.88%
6/13/17	TCG BDC, Inc.	NasdaqGS:CGBD	166,500.0	18.50	17.91	(2.1%)	(1.6%)	(3.2%)	0.990	0.121	1,120.6	8.32%
6/9/17	Monroe Capital Corporation	NasdaqGS:MRCC	45,000.0	15.00	12.66	0.7%	(0.5%)	(15.6%)	0.919	0.121	256.2	8.90%
6/7/17	Golub Capital BDC, Inc.	NasdaqGS:GBDC	32,743.0	18.71	17.86	3.7%	2.6%	(4.5%)	1.113	0.242	1,067.0	6.44%
5/18/17	Goldman Sachs BDC, Inc.	NYSE:GSBD	73,125.0	22.50	19.09	(0.2%)	0.6%	(15.2%)	1.055	0.149	766.5	7.31%
5/16/17	Alcentra Capital Corporation	NasdaqGS:ABDC	34,200.0	13.68	6.00	(1.0%)	(2.6%)	(56.1%)	0.541	0.087	85.2	9.90%
5/9/17	Gladstone Investment Corporation	NasdaqGS:GAIN	19,698.0	9.38	10.91	(3.5%)	(1.3%)	16.3%	1.052	0.209	354.9	8.87%
4/19/17	TCP Capital Corp.	NasdaqGS:TCPC	84,200.0	16.84	14.29	0.0%	(0.4%)	(15.1%)	0.966	0.266	840.9	8.52%
4/5/17	Stellus Capital Investment Corporation	NYSE:SCM	38,775.0	14.10	12.69	(0.7%)	(0.6%)	(10.0%)	0.919	0.096	202.5	11.27%
4/4/17	New Mountain Finance Corporation	NYSE:NMFC	73,000.0	14.60	13.40	(1.0%)	0.0%	(8.2%)	0.983	0.375	1,017.5	9.65%
3/30/17	OFS Capital Corporation	NasdaqGS:OFS	51,870.0	14.82	10.67	(4.3%)	(2.4%)	(28.0%)	0.781	0.057	142.4	9.88%
3/21/17	Golub Capital BDC, Inc.	NasdaqGS:GBDC	33,303.0	19.03	17.86	0.2%	5.6%	(6.1%)	1.113	0.242	1,067.0	6.96%
2/27/17	Triangle Capital Corporation	NYSE:TCAP	136,500.0	19.50	11.60	(0.8%)	(2.7%)	(40.5%)	0.868	0.467	557.1	9.81%
2/14/17	PennantPark Floating Rate Capital Ltd.	NasdaqGS:PFLT	70,423.0	14.08	13.23	(3.1%)	(1.9%)	(6.1%)	0.954	0.256	513.0	8.08%
1/25/17	Newtek Business Services Corp.	NasdaqGM:NEWT	34,313.0	15.25	17.74	1.0%	7.1%	16.3%	1.179	0.108	329.0	12.06%
11/29/16	Fidus Investment Corporation	NasdaqGS:FDUS	46,620.0	16.65	12.95	(2.8%)	(5.3%)	(22.2%)	0.797	0.122	316.8	9.90%
10/26/16	Gladstone Capital Corporation	NasdaqGS:GLAD	15,960.0	7.98	8.61	(1.1%)	4.1%	7.9%	0.992	0.127	229.3	11.60%
10/25/16	New Mountain Finance Corporation	NYSE:NMFC	68,750.0	13.75	13.40	(1.8%)	1.5%	(2.5%)	0.983	0.375	1,017.5	10.54%
9/8/16	Solar Senior Capital Ltd.	NasdaqGS:SUNS	67,040.0	16.76	16.95	(4.5%)	(2.7%)	1.1%	1.006	0.045	271.9	8.75%
8/15/16	Golub Capital BDC, Inc.	NasdaqGS:GBDC	32,113.0	18.35	17.86	2.2%	0.7%	(2.7%)	1.113	0.242	1,067.0	7.08%
7/26/16	Triangle Capital Corporation	NYSE:TCAP	124,375.0	19.90	11.60	(0.7%)	(0.3%)	(41.7%)	0.868	0.467	557.1	10.50%
7/20/16	Monroe Capital Corporation	NasdaqGS:MRCC	48,050.0	15.50	12.66	(0.4%)	2.8%	(18.3%)	0.919	0.121	256.2	10.11%
7/7/16	TCP Capital Corp.	NasdaqGS:TCPC	35,259.0	15.09	14.29	2.7%	5.1%	(5.3%)	0.966	0.266	840.9	9.66%
5/27/16	Fidus Investment Corporation	NasdaqGS:FDUS	38,175.0	15.27	12.95	(0.5%)	(1.2%)	(15.2%)	0.797	0.122	316.8	10.06%
		Mean	$58,535.7	$15.84	$13.86	(1.0%)	0.2%	(11.5%)	0.950	0.202	$571.9	9.23%
		Median	46,620.0	15.27	13.23	(0.8%)	(0.3%)	(7.2%)	0.966	0.149	513.0	9.65%

Data as of April 25, 2018.

(1): Excludes over-allotment.