Congressional Testimony H.R. 1800 AND H.R. 31
Written

Legislation to Further Reduce Impediments to Capital Formation

Small Business Credit Availability Act (H.R. 1800)
Next Steps for Credit Availability Act (H.R. 31)

Alexander C. Frank

As Chief Financial Officer and Partner of Fifth Street Management LLC, I appreciate the opportunity to testify on the implications of H.R. 1800 and H.R. 31. Fifth Street is an alternative asset manager with over $3 billion in assets under management and the SEC-registered investment adviser of two publicly-traded business development companies. Our team has a 15 year track record financing small and mid-sized companies, primarily in connection with investments by private equity sponsors.

BDCs like Fifth Street play an essential role in the new paradigm of middle market lending. As traditional banks have shied away from lending to small and mid-sized private businesses, alternative lenders like BDCs have filled the void, emerging as the primary conduit between banks and smaller companies that are non-investment grade credits. Consider that nine years ago, there were just four publicly-traded BDCs. Today, there are roughly ten times as many—or approximately 40 publicly-traded BDCs—and we estimate that within the next few years, BDC assets will eclipse $100 billion.

Despite the growing importance of BDCs in helping finance small and mid-sized companies in our economy today, the BDC industry is still burdened by legacy regulations that create an uneven playing field while needlessly costing the industry significant amounts of time and money each year. Since BDCs are pass-through vehicles, that cost is borne not just by BDC shareholders, but by the small businesses BDCs serve as well.

Several aspects of both H.R. 1800 and H.R. 31 could go a long way towards “modernizing the BDC regulatory framework.” First, allowing BDCs to own interests in registered investment advisers is a shareholder-friendly step that would offer investors incremental fee-based revenue. Second, permitting BDCs to issue preferred equity that would be considered regulatory capital could be viewed as equally favorable—BDCs would gain a new source of funding, while investors would benefit from less dilution from additional issuance of common equity shares. Finally, if SEC registration is streamlined, BDCs should become more agile, tapping the capital markets more quickly and having the ability to pursue opportunities as they arise. The latter two provisions, in particular, will bring much-needed parity to the BDC industry vis a vis counterparts like REITs and MLPs.

Collectively, such modernization would represent a positive development for an industry that is playing an increasingly important role in financing underserved small and mid-sized U.S. companies. However, when it comes to reducing asset coverage requirements—which would allow for more aggressive balance sheet leverage—H.R. 1800 and H.R. 31 may not be appropriate in all cases, or for all asset classes, and I believe requires further review. Prudently-managed BDCs with efficient operations simply are not challenged by a lack of capital today. In fact, the BDC industry as a whole witnessed a multitude of securities issuances in 2012 and that trend has continued into 2013.

Investment grade rated BDCs issued close to $1.3 billion in public equity for the full 2012 calendar year, a 300% increase compared with all of 2011.[1] With ample capital to deploy, well-run BDCs easily maintained leverage levels below statutory minimums—the industry's average debt/equity ratio stood at approximately 0.4x equity last year. According to Fitch Ratings, unsecured debt issuances totaled $1.9 billion across six rated BDCs in 2012 and 1Q13, versus just $545 million across three rated BDC issuers in 2011.[2]

In reality, the single biggest hurdle that prevents a BDC from attracting new capital is having a stock price that trades below net asset value (NAV), or book value. BDCs are not permitted to sell shares below net asset value without shareholder approval. Approval notwithstanding, the invisible hand of the market serves as a natural constraint against BDCs with discounted NAVs. It is difficult to successfully raise equity when one's stock (or, at times, the entire sector) is out of favor.

A number of factors influence a BDC's NAV, including dividend policy, the prospect for dilutive equity raises and above all, the credit performance of a BDC's underlying portfolio. On the latter front—under the existing leverage rules—the industry's overall track record has been strong. Cumulative realized and unrealized losses for the BDC industry average at a rate of around 70 basis points annualized, which compares favorably to a 257 basis points annualized rate for commercial banks.[3] Thus, while banks may gravitate toward more liquid assets, BDCs have demonstrated relatively superior credit performance.

Yet, there have still been notable exceptions. At the peak of the credit cycle in 2006-2007, two prominent BDCs overextended their debt capacity as a means of fueling aggressive portfolio growth. Unfortunately, the timing was disastrous. A series of write-downs led to violations of credit facility covenants, which resulted in restructurings and the eventual cessation of dividend payments. In the end, equity investors suffered considerable losses.

Several lessons can be learned from this cautionary tale. First, a few high-profile mistakes can tarnish the entire industry. This is especially true in a sector that tends to be viewed as a monolith—as evidenced by the fact that virtually the entire BDC industry trades in a narrow range in terms of price-to-book. The misguided decisions of two players who borrowed imprudently in pursuit of growth still haunt the industry today. As well-managed BDCs shake off the lingering pall of investor misconceptions, it would be counterproductive to raise the specter of expanded leverage.

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[1] "BDC Unsecured Issuance Bolstering Funding Flexibility," April 9, 2013. Fitch Ratings.
[2] Ibid.
[3] "The BDC Almanac--Part Deux," January 23, 2013. Wells Fargo Securities.

The second key lesson is the importance of having diversified sources of funding. Today, large BDCs enjoy multiple pockets of funding. This diversification reduces the likelihood of a potential liquidity squeeze. However, smaller BDCs may not be able to afford the luxury of varied funding sources. Even so, under current asset coverage requirements, it might still be feasible for a smaller BDC to approach the public equity markets to replace funding from a pulled credit line. Under the newly proposed guidelines, however, the potential hole could be too large to fill.

The final lesson that can be gleaned is that BDC investors place a high premium on stability. Investors in BDCs are attracted to the potential for healthy dividend yields with low leverage. It is that combination that makes the BDC model uniquely compelling: robust current income without undue risk. Because BDCs pay dividends based on the taxable income they earn, investors generally feel secure knowing that dividends are supported by relatively stable, predictable cash flows.

Today, the Securities & Exchange Commission does a highly effective job enforcing the current leverage ratio. In our view, the 1:1 ratio—and its strict SEC oversight—contributes to a reputation for safety that is appreciated by both BDC investors and nationally recognized rating agencies alike. Altering the leverage profile in the BDC model would inevitably lead to higher default risk—to the detriment of the investment calculus.

Investors are not the only ones who would likely feel compelled to re-evaluate the BDC model if leverage beyond the traditional 1:1 requirement is permitted. Rating agencies—instrumental in helping BDCs become a more entrenched institutional asset class—would likely view the development as unfavorable, too.

As nationally recognized ratings agencies incorporate the higher risk of defaults into their models, downgrades could follow. Even those BDCs who adopt a more conservative approach could be penalized, as agencies would need to account for potential competitive pressures to expand leverage.

A change in position could not come at a worse time for the industry. New risk-based capital weightings under Basel III are likely to mandate that banks increase equity capital reserves for leveraged loans. While many view this as a positive development for BDCs—assuming decreased bank competitiveness in the middle market space—potential credit downgrades could undercut any upside.

At best, a non-investment grade credit rating would increase a BDC's cost of capital on bank credit facilities. At worst, it could make institutional investors less receptive to BDCs at a time when an uptick in unsecured debt issuances is enhancing BDCs' funding diversity.

In short, credit downgrades would be an unwelcome surprise at a time when BDCs should be capitalizing on the tailwinds of supportive capital markets for unsecured debt and increased market share potential due to Basel III.

This discussion would not be complete without mentioning "effective leverage", which takes into account, on a look-through basis, leverage of the underlying assets in which a BDC invests. In other words, it's important to recognize that BDCs often provide expansion capital to their portfolio companies who are often heavily leveraged themselves.

Effective leverage is an important concept because it shows the true risk in a BDC's balance sheet. Wells Fargo Securities, LLC estimates the BDC peer group average at 3.5x, but the most highly levered BDCs have effective leverage ratio estimates over 5.5x.[4] If H.R. 1800 or H.R. 31 is enacted in its current form, BDCs with already high levels of effective leverage could essentially double their effective leverage up to 11x.

Not all BDCs are alike—and 1:1 leverage may not be precisely the right level. Yet, a drastic move from 1:1 to 2:1 leverage in one step might benefit a handful of BDCs while working to the detriment of the vast majority. During this period of high growth and increasing small-business reliance on BDCs, completely removing the safety rails does not seem judicious. Having reduced the amount of risk in the financial system by requiring banks to hold more capital to support the risks associated with lending to non-investment grade companies—only to shift that risk to entities already operating more responsibly—appears imprudent and could significantly undermine the long-term vision that the bills set out to achieve.

The BDC industry stands at a crossroads: BDCs are considered an emerging asset class and the industry is growing swiftly. In fact, industry analysts see parallels between BDCs and two other investment vehicles, Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs), which also started out as relatively obscure, niche investments. Now, REITS and MLPs are highly successful, well-established asset classes. All indications are that BDCs could continue to provide very good investment opportunities—provided the industry avoids reputational damage and other hurdles that could undermine its prospects.

Many BDCs would welcome either H.R. 1800 or H.R. 31 as it is currently written, and three provisions seem both prudent and beneficial. However, from a fiduciary perspective and the protection of shareholder capital, increasing the leverage threshold potentially risks shrinking the pool of capital available to BDCs and choking off liquidity to the "young, rapidly growing companies" it is designed to help.

[4] (Wells Fargo Securities, The Q3 2013 BDC Scorecard, June 14, 2013, page 50)