Business Development Companies Are Facing Reduced Asset Coverage Requirements And Heated Competition In Middle-Market Lending

July 31, 2018

Business development companies--or BDCs, which help finance small and midsize companies--have been in operation since 1980, and this year, they experienced one of the most substantial changes in their history: the Small Business Credit Availability Act (SBCAA). The SBCAA, signed into law in March, allows a company that receives approval from its shareholders or board of directors to reduce its asset coverage requirement to 150% from 200%. This allows companies to borrow roughly $2 for every $1 of equity.

In S&P Global Ratings' opinion, the potential for higher leverage, in an already competitive environment, increases credit risk in the BDC industry. The legislation could provide BDCs more flexibility in stress scenarios when assets are marked down temporarily, and it could allow BDCs to achieve targeted returns on equity while making lower-yielding loans. That said, we do not think there will be wholesale changes to BDCs' underlying risk. We believe that it will mainly entice BDCs to increase leverage without significantly reducing the risk on their portfolios.

In addition to the SBCAA, the other main factor for BDCs through the rest of this year is the extremely high competition in middle-market lending. According to a white paper by Ares Management in April 2018, the total middle-market loan volume is an estimated $910 billion. In total, BDCs have about $90 billion in assets. They typically fund companies that have difficulty accessing traditional bank financing because they are smaller or less creditworthy than companies that banks usually lend to.

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Overview

- Business development companies (BDCs) are taking different approaches to the Small Business Credit Availability Act (SBCAA), but we expect many will opt to decrease their required asset coverage and, thereby, increase their leverage limitations in the next 12-24 months, which will generally result in negative rating actions.
- In our opinion, competition in middle-market lending has remained extremely high, but the economic backdrop should remain supportive, notwithstanding the likelihood for a steady increase in short-term interest rates.
- BDCs generally are performing adequately, albeit in a relatively benign credit environment.

The SBCAA Has Already Led To Some Rating Actions

We have downgraded three BDCs (two of which requested to have the ratings withdrawn) that have announced approvals for higher leverage. We have negative outlooks on seven BDCs (see table 1) because we are uncertain whether those companies will pursue higher leverage, as well as any associated changes to their strategies or financial management. We likely will downgrade by one notch BDCs that obtain approval to reduce their applicable asset coverage ratios. Further downgrades of those BDCs that obtain approval could follow, depending on how significantly they increase leverage, the level and stability of earnings, and investment portfolio composition. Moreover, at the speculative-grade level, the ratings on senior unsecured debt issuances could fall up to two notches below the issuer credit rating, depending on the amount of priority debt and unencumbered assets.

Historically, low leverage (less than 1.0x debt to equity) was a key factor that helped BDCs achieve investment-grade ratings. Following the passage of the SBCAA, we lowered the preliminary anchor for BDCs to 'bb+', in line with other U.S. nonbank finance companies, from 'bbb-'. (The preliminary anchor is the starting point for our ratings on BDCs and reflects our view of the economic and industry risks these companies face.) While we have lowered the preliminary anchor, we apply entity-specific adjustments to BDCs that elect to maintain the legacy 200% asset coverage requirements, resulting in final anchors of 'bbb-' for those BDCs.

Table 1

Business Development Companies Ratings And Assessments

Company	Final anchor§	Business position	Capital, leverage, and earnings	Risk position	Funding/liquidity	Comparable ratings adjustment	SACP	ICR
Apollo Investment Corp.*	bb+	Adequate	Very Strong	Weak	Adequate/Adequate	Neutral	-	Not rated
Ares Capital Corp.	bb+	Adequate	Very Strong	Moderate	Adequate/Adequate	Neutral	bbb-	BBB-/Stable/--
BlackRock Capital Investment Corp.	bbb-	Moderate	Very Strong	Weak	Adequate/Adequate	Positive	bbb-	BBB-/Negative/--
Corporate Capital Trust	bbb-	Adequate	Very Strong	Moderate	Moderate/Adequate	Neutral	bbb-	BBB-/Stable/--
FS Investment Corp.	bbb-	Adequate	Very Strong	Weak	Adequate/Adequate	Neutral	bbb-	BBB-/Stable/--
Goldman Sachs BDC Inc.*	bb+	Adequate	Very Strong	Moderate	Moderate/Adequate	Neutral	-	Not rated
Hercules Capital Inc.	bbb-	Moderate	Very Strong	Moderate	Adequate/Adequate	Neutral	bbb-	BBB-/Negative/--
Main Street Capital Corp.	bbb-	Adequate	Very Strong	Moderate	Adequate/Adequate	Neutral	bbb	BBB/Stable/--

Table 1

Business Development Companies Ratings And Assessments (cont.)

Company	Final anchor§	Business position	Capital, leverage, and earnings	Risk position	Funding/liquidity	Comparable ratings adjustment	SACP	ICR
Oaktree Specialty Lending Corp.	bbb-	Moderate	Very Strong	Weak	Adequate/Adequate	Neutral	bb+	BB+/Stable/--
Owl Rock Capital Corp.	bbb-	Adequate	Very Strong	Moderate	Moderate/Adequate	Neutral	bbb-	BBB-/Stable/--
PennantPark Investment Corp.	bbb-	Adequate	Very Strong	Weak	Adequate/Adequate	Neutral	bbb-	BBB-/Negative/--
Prospect Capital Corp.	bbb-	Adequate	Strong	Moderate	Adequate/Strong	Neutral	bbb-	BBB-/Negative/--
Solar Capital Ltd.	bbb-	Adequate	Very Strong	Moderate	Moderate/Adequate	Neutral	bbb-	BBB-/Negative/--
TCP Capital Corp.	bbb-	Moderate	Very Strong	Moderate	Adequate/Adequate	Neutral	bbb-	BBB-/Negative/--
TPG Specialty Lending Inc.	bbb-	Adequate	Very Strong	Moderate	Adequate/Adequate	Negative	bbb-	BBB-/Negative/--

Note: As of July 31, 2018. *The ratings on Apollo Investment Corp. and Goldman Sachs BDC Inc. were withdrawn June 29, 2018, and June 15, 2018, respectively. §The preliminary anchor for BDCs is 'bb+'. For those that maintain the legacy 200% asset coverage requirement, we incorporate a positive entity-specific adjustment that results in a 'bbb-' anchor. SACP--Stand-alone credit profile. ICR--Issuer credit rating.

The History Of BDCs

BDCs were created in 1980 as an amendment to the Investment Company Act of 1940. While they still make up a relatively small size of the overall middle market, they have benefited from the disintermediation of banks following the financial crisis of 2008. Most BDCs we rate are listed and trade on stock exchanges. Given their Regulated Investment Company (RIC) status and investors' expectations for a steady dividend, many BDCs are heavily skewed toward fixed-income investments.

Board Approval, Shareholder Approval, Or Wait And See?

Given BDCs' existing shareholder bases, the ability to increase leverage is not a foregone conclusion. BDCs need to request approval from either their boards of directors or their shareholders in order to utilize the additional levels of leverage. If a BDC goes the board of directors route to receive approval, it can increase leverage one year from the date of approval. If a BDC receives shareholder approval, it can increase leverage immediately. An interesting twist is that non-traded BDCs must offer liquidity to their shareholders over the course of one year if they gain approval. For this reason, we believe that non-traded and private BDCs that formed prior to the legislation are unlikely to increase leverage until they are publicly traded.

To date, BDCs have taken different actions with respect to the SBCAA (see table 2):

- Some have been relatively silent as they assess the views of their different constituents.
- Some have sought approval from their boards of directors, which would allow the companies to increase leverage one year from the date approval.
- One has sought shareholder approval.

Table 2

Actions BDCs Have Taken With Respect To The SBCAA

BDC	BDC action	S&P Global Ratings' rating action
Apollo Investment Corp.	Received board approval on April 4, 2018	Rating lowered to 'BB+' on April 23, 2018, and subsequently withdrawn at issuer's request on June 29, 2018
Ares Capital Corp.	Received board approval on June 21, 2018, not seeking shareholder approval	Downgraded to 'BBB-' on June 25, 2018; the outlook is stable
BlackRock Capital Investment Corp.	No announced action	The 'BBB-' rating remains on negative outlook
Corporate Capital Trust	No announced action	The 'BBB-' rating remains on negative outlook
FS Investment Corp.	Initially received board approval but later decided not to modify the asset coverage ratio	'BBB-' rating affirmed and removed from CreditWatch on April 16, 2018; outlook is stable
Goldman Sachs BDC, Inc.	Received shareholder approval on June 15, 2018, to immediately implement the 150% asset coverage metric	Issuer credit rating lowered to 'BB+' and subsequently withdrawn at issuer's request on June 15, 2018
Hercules Capital Inc.	No announced action	The 'BBB-' rating remains on negative outlook
Main Street Capital Corp.	Announced that it will currently operate under the legacy 200% asset coverage test	'BBB' issuer credit rating affirmed and outlook revised to stable on May 4, 2018
Oaktree Specialty Lending Corp.	Announced that it will currently operate under the legacy 200% asset coverage test	'BB+' issuer credit rating affirmed and outlook revised to stable on May 14, 2018
Owl Rock Capital Corp.	We do not believe the company will pursue higher leverage because of the requirement for non-traded BDCs that gain approval to offer shareholders liquidity over the course of one year.	Assigned a 'BBB-' rating on April 11, 2018; the outlook is stable
PennantPark Investment Corp.	No announced action	The 'BBB-' rating remains on negative outlook
Prospect Capital Corp.	Initially received board approval but later decided not to modify the asset coverage ratio	Affirmed the 'BBB-' issuer credit rating; the outlook is negative
Solar Capital Ltd.	No announced action	The 'BBB-' rating remains on negative outlook
TCP Capital Corp.	No announced action	The 'BBB-' rating remains on negative outlook
TPG Specialty Lending Inc.	No announced action	The 'BBB-' rating remains on negative outlook

We believe the BDCs that have not announced specific actions will continue to contemplate and weigh the pros and cons relative to their different constituents. We expect that, over time, many BDCs will opt to decrease their required asset coverage and, thereby, increase their leverage limitations.

Many BDCs that have gained approval for higher leverage have announced fee cuts so that the economics of higher leverage do not all accrue to the manager. Goldman Sachs announced it would reduce its base management fee to 1% of total assets. Ares Capital Corp. and Apollo Investment Corp. announced that they would reduce the base management fee on assets acquired using the leverage beyond 1.0x (on a debt-to-equity basis) to 1%. However, lower fees do not directly affect BDC creditors because RICs distribute substantially all of their earnings as dividends. But, lower fees can help the BDCs meet their dividends through stable and recurring earnings, thereby lowering the chance that the dividends will represent a return of capital to shareholders.

On Repeat: Middle-Market Lending Remains Extremely Competitive

Middle-market lending halfway through 2018 is simply more of the same--underwriting standards remain loose, in our view, corporate leverage is increasing, and new issue yields remain near historical lows. Although BDCs are typically asset sensitive and stand to benefit if rates rise, due to floating-rate assets, we think there could be underlying stress at the portfolio companies if aggressive tightening of monetary policy occurs beyond the expectations of S&P Global's economists. (Our economists continue to expect a total of four Fed rate hikes this year and three in 2019.) In short, we remain very cautious about the industry backdrop and believe that we are closer to the end of the cycle than the beginning.

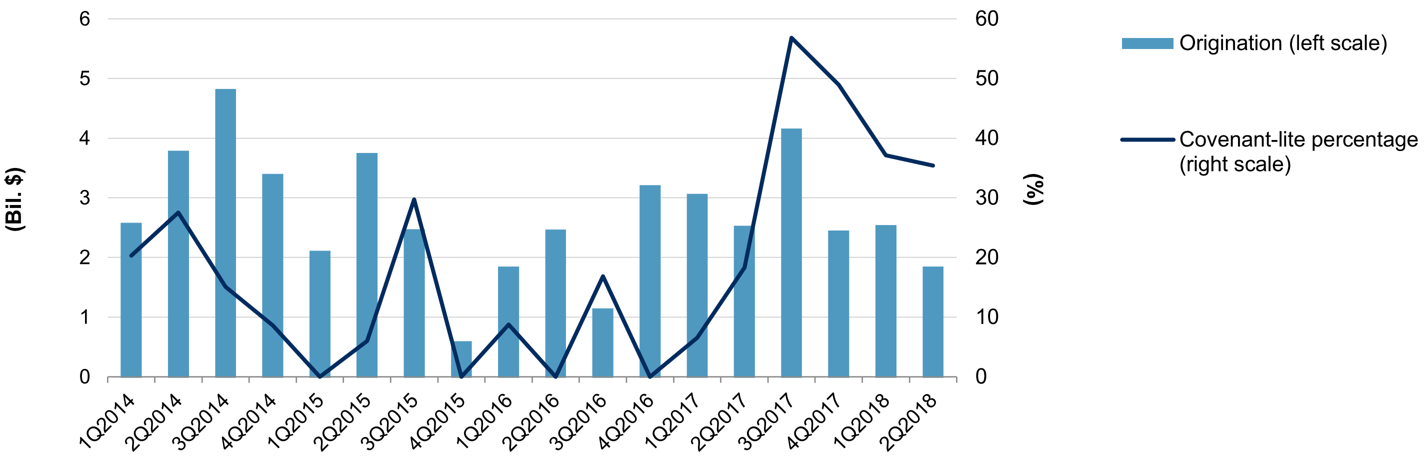
That said, we believe relaxed underwriting standards have been present for quite some time. At this point, we do not see any immediate weakness in the middle market without some type of broader macroeconomic hiccup. (S&P Global economists forecast real GDP growth of 3% in 2018 and 2.5% in 2019.) Consequently, we expect to be discussing a similar market outlook in January 2019 and believe that the middle-market fundamentals will continue at least through the end of 2018.

Middle-market origination: decreasing supply

Middle-market origination declined during the first half of 2018, although covenant-lite loans still constitute a sizable portion of the new origination market (chart 1). Approximately $2.5 billion and $1.8 billion of middle-market loans (deal size less than $350 million) were issued in the first and second quarters of 2018, respectively, down from the recent high of $4.1 billion in third-quarter 2017. Covenant-lite loans are elevated as the market remains competitive and lenders are willing to accept deals with looser terms and worse pricing to win deals. Covenant-lite loans were 35% of origination, down from 57% but well above the average of 19% over the past four years.

Chart 1

Middle-Market Leveraged Lending Breakdown
(Deal Size Less Than $350 Million)



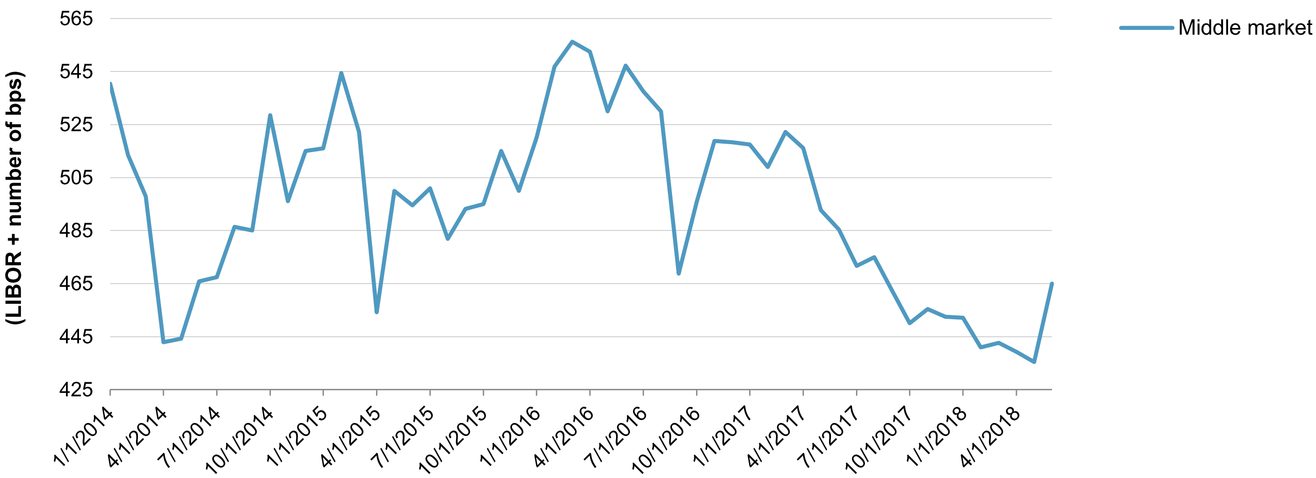
Source: LCD Data, S&P Global Ratings' format.

New issue leveraged loan spreads remain near lows. Current spreads (as of second-quarter 2018) were LIBOR + 465 basis points (bps) (see chart 2). Spreads are up from lows set in May 2018, at LIBOR + 435 bps, but well below the four-year average of LIBOR + 500 bps. It is possible spreads could widen further, but we think new loan spreads are somewhat capped for now. There is a lot of excess capital in search for yield. BDCs typically invest in much higher yields than this (generally 8%-12%), but we use it as a proxy to judge the overall conditions in the middle market.

The demand for leveraged loans remains strong, as evidenced by high demand from CLOs (over $35 billion of volume in the second quarter of 2018, according to S&P Global Market Intelligence's Leveraged Commentary & Data) and loan mutual funds/exchange-traded funds. We believe that the demand for middle-market loans remains strong as well given the increasing number of direct lending vehicles, both inside and out of the BDC structure. FS Investment Corp. and an affiliate of KKR & Co. recently closed on their joint venture to manage the largest platform of BDCs. A number of news outlets have reported that Blackstone's GSO Capital Partners has a $10 billion investment target for its direct lending efforts. It will likely be through a combination of a BDC structure and separately managed accounts.

Chart 2

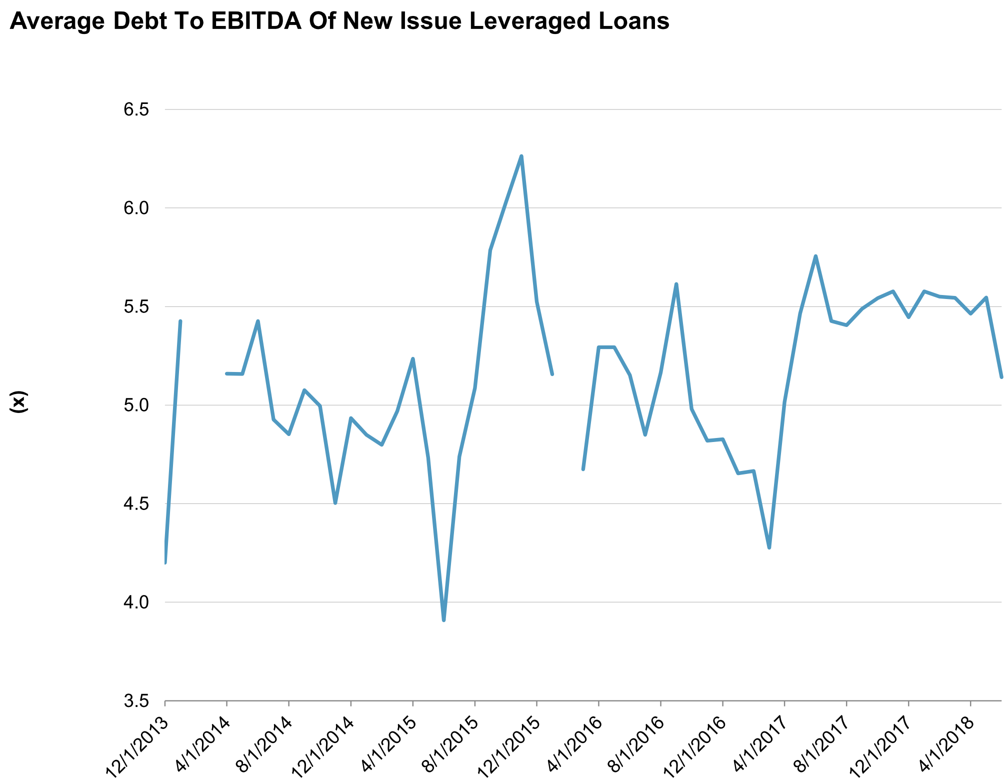
Average New Issue Leveraged Loan Spreads



Source: LCD Data, S&P Global Ratings' format.

Not surprisingly, companies have taken advantage of benign credit conditions. Average debt to EBITDA of newly issued loans was 5.1x at the end of second-quarter 2018 (see chart 3). This has dipped slightly over the past several years but remains well above the historical average of 3.9x. We believe another sign of aggressive underwriting is the numerous beneficial adjustments made to EBITDA. These can include one-time, nonrecurring cost savings. As a result, it is likely that middle-market companies' true leverage levels are higher than what the data are indicating.

Chart 3



Source: LCD Data, S&P Global Ratings' format.

The Main Factors We Consider In Analyzing BDCs' Portfolio Risk And Underwriting

The majority of BDCs we rate commenced operations after the 2008 financial crisis and therefore have limited experience operating through the trough of an economic cycle (although the management teams typically have extensive private lending experience). The only real test thus far has been the dip in commodity prices that began in mid-2014 (also a temporary dip in fair values in early 2016).

We judge portfolio risk and underwriting capability through a number of lenses. We look at cumulative gains and losses as a percentage of average investments, nonaccrual rates of loans on a cost basis, portfolio yield (with higher yield implying higher risk), and the amount of paid-in-kind (PIK) income that the company receives. We also analyze portfolio construction, in terms of priority of claims (e.g., first-lien, second-lien, first-lien last out, etc.) and concentration by industry and obligor.

Outsize Losses Are Limited To A Small Number Of BDCs

Given the risky nature of underlying loans, we expect some level of losses, even in a benign credit environment. We believe it will be important for management teams to price the commensurate risk appropriately. Apollo Investment Corp., BlackRock Capital Investment Corp., and Oaktree Specialty Lending Corp. have been outliers, with average losses as a percentage of investments exceeding 4% (see table 3).

Table 3

BDC Gains And Losses

	AINV	ARCC	BKCC	CCT	FSIC	GSBD	HTGC	MAIN	OCSL	ORCC	PNNT	PSEC	SLRC	TCPC	TSLX
Realized gains and losses/average investments (%)															
2018*	(13.3)	0.1	(8.6)	(2.6)	(1.2)	(5.3)	(2.4)	(0.2)	(1.8)	N/A	3.3	(2.0)	(0.9)	(1.1)	(0.7)
2017	(11.3)	0.2	(6.2)	(2.0)	(3.7)	(5.4)	(1.8)	0.5	(9.3)	0.0	(2.7)	(1.6)	(0.9)	(1.5)	(0.8)
2016	(1.6)	1.2	(8.3)	(0.1)	(1.6)	(2.0)	0.3	1.5	(5.5)	N/A	(6.6)	(0.4)	0.1	(1.2)	(0.0)
2015	(6.2)	1.4	10.3	1.6	(1.5)	(0.0)	0.5	(1.3)	(1.2)	N/A	2.3	(2.8)	(0.4)	(1.5)	(0.2)
2015-2017 average	(6.4)	1.0	(1.4)	(0.2)	(2.3)	(2.5)	(0.3)	0.3	(5.3)	0.0	(2.3)	(1.6)	(0.4)	(1.4)	(0.4)
Unrealized gains and losses/average investments (%)															
2018*	10.7	1.9	3.6	1.5	(0.6)	3.1	1.8	2.6	(10.9)	N/A	(4.1)	1.4	1.0	(0.0)	0.4
2017	9.3	1.3	2.3	1.1	3.2	2.9	0.6	2.3	(5.3)	0.5	3.1	0.9	1.0	(0.2)	0.3
2016	(3.4)	(1.5)	(5.2)	0.9	3.9	(1.2)	(2.8)	(0.4)	(2.1)	N/A	2.3	(3.9)	2.7	1.2	1.9
2015	(1.4)	(2.7)	(13.4)	(8.2)	(4.0)	(2.8)	(3.2)	0.6	(2.9)	N/A	(9.4)	2.6	(3.9)	(0.4)	(2.1)
2015-2017 average	1.5	(1.0)	(5.4)	(2.1)	1.0	(0.4)	(1.8)	0.8	(3.4)	0.5	(1.3)	(0.1)	(0.1)	0.2	0.0
Gains and losses/average investments (%)															
2018*	(2.6)	2.0	(5.0)	(1.1)	(1.8)	(2.2)	(0.6)	2.3	(12.6)	N/A	(0.8)	(0.5)	0.2	(1.1)	(0.3)
2017	(2.0)	1.5	(3.9)	(0.9)	(0.6)	(2.5)	(1.2)	2.9	(14.5)	0.6	0.5	(0.8)	0.1	(1.6)	(0.5)
2016	(5.0)	(0.2)	(13.5)	0.9	2.2	(3.2)	(2.4)	1.2	(7.6)	N/A	(4.2)	(4.3)	2.7	0.0	1.9
2015	(7.6)	(1.3)	(3.1)	(6.7)	(5.5)	(2.8)	(2.8)	(0.7)	(4.1)	N/A	(7.1)	(0.2)	(4.3)	(1.9)	(2.3)
2015-2017 average	(4.9)	0.0	(6.8)	(2.2)	(1.3)	(2.8)	(2.1)	1.1	(8.7)	0.6	(3.6)	(1.8)	(0.5)	(1.2)	(0.3)

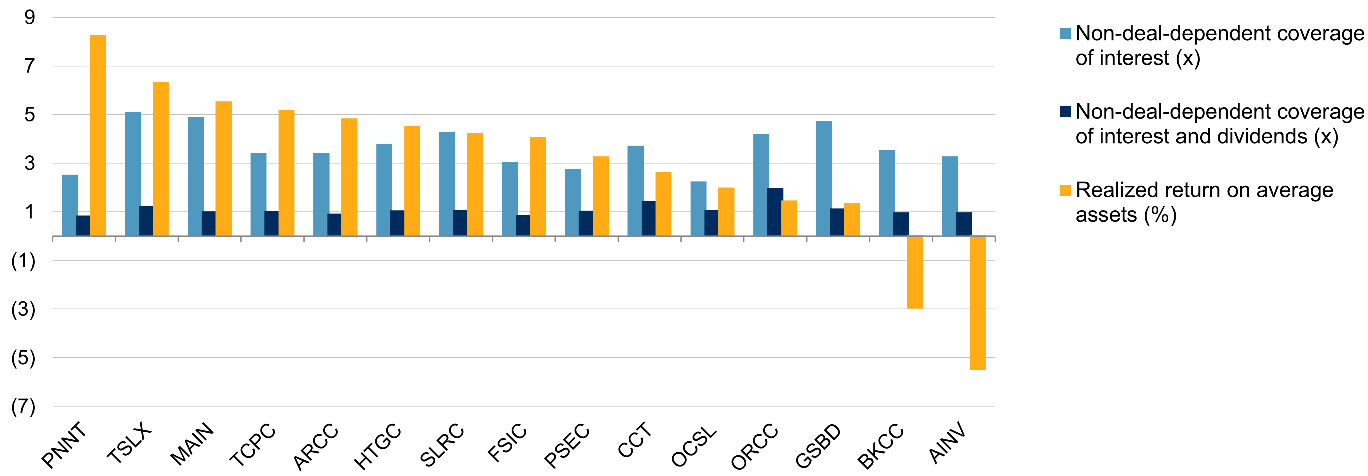
Note: GSBD and AINV are no longer rated. *Rolling 12 months as of March 31, 2018. MAIN--Main Street Capital Corp. PNNT--PennantPark Investment Corp. AINV--Apollo Investment Corp. BKCC--BlackRock Capital Investment Corp. SLRC--Solar Capital Ltd. CCT--Corporate Capital Trust. OCSL--Oaktree Specialty Lending Corp. HTGC--Hercules Capital Inc. GSBD--Goldman Sachs BDC Inc. PSEC--Prospect Capital Corp. ARCC--Ares Capital Corp. FSIC--FS Investment Corp. TCPC--TCP Capital Corp. TSLX--TPG Specialty Lending Inc. ORCC--Owl Rock Capital Corp. Source: Company filings.

As we have noted in the past, Apollo Investment, Oaktree Specialty Lending, and BlackRock Capital have transitioned management teams and have realized losses as they rotate their portfolios out of legacy positions.

In addition to gains and losses on investments, we also review a company's ability to cover its interest by at least 3.0x and its interest and dividends by 1.0x through what we consider to be stable and recurring earnings. Those with higher levels of PIK (PennantPark Investment Corp., FS Investment, and BlackRock Capital) typically have more difficulty meeting these ratios because we deduct this from our measure of stable earnings. In a low interest rate environment, most BDCs are adequately able to cover their interest expense by 3.0x with stable earnings.

Chart 4

Earnings And Coverage Metrics
(Last 12 Months As Of March 31, 2018)



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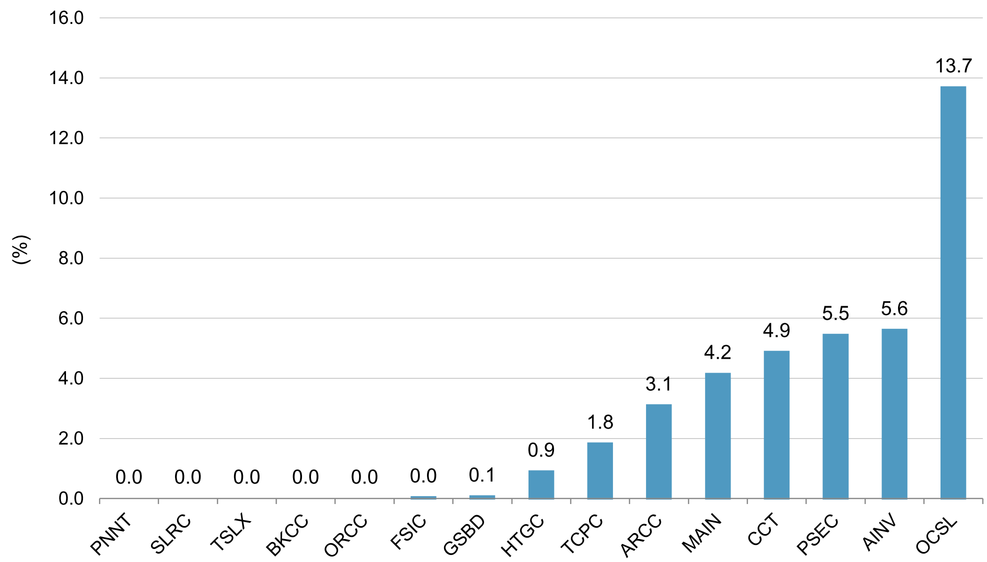
Nonaccrual Rates Remain Subdued For Most Rated BDCs

The benign market environment has translated into low nonaccrual loans at most BDCs that we rate. Nearly half reported zero loans on nonaccrual status in the first quarter of 2018. However, BDCs have some discretion in their recognition of nonperforming loans. For example, many BDCs will classify a loan as nonaccrual when they are doubtful that the company will pay. Others wait until a payment is missed. Moreover, some BDCs take a more proactive stance and restructure loans early in the process, thereby removing the loan from nonaccrual status. Furthermore, BDCs can sell out of positions early, realizing losses but removing nonaccrual investments from the portfolio.

Overall, nonaccruals across the portfolio are markedly lower than last year. Oaktree Specialty Lending, which at one time operated with nearly 20% of loans on nonaccrual (as a percentage of total loans at cost), has restructured or recognized a loss on a significant portion of its portfolio (see chart 5). Similarly, BlackRock Capital, which typically operated with nonaccruals above the peer average, has no loans on nonaccrual status as of March 31, 2018.

Chart 5

Nonaccruals/Loans At Cost



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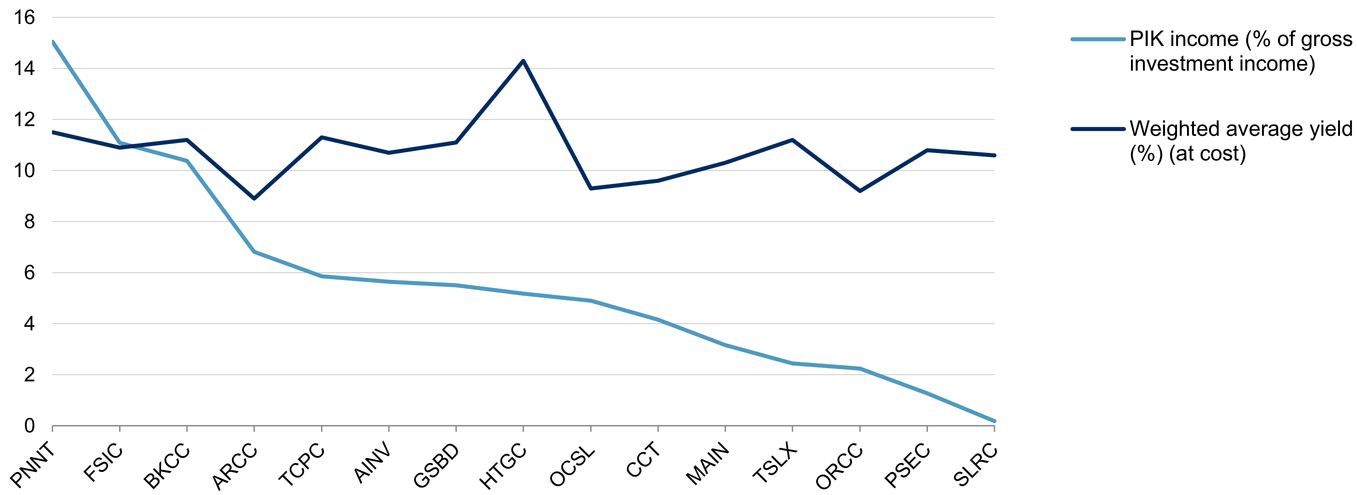
Yield And PIK: Indicators Of What Is To Come?

While unrealized appreciation/depreciation on the balance sheet can be a harbinger of future realized losses, we look to positions in the capital structure, average portfolio yield, and the level of PIK income a BDC is receiving as indicators of risk (see chart 6). However, any one of these wouldn't necessarily indicate a company is more risky; we consider a lot of factors. For example, while Hercules Capital has a higher level of yield, it also has a differentiated business model from peers we rate similarly. While LIBOR has risen steadily over the last few years, the average new issue leveraged loan spreads have only recently started to increase. Therefore, portfolio yields have been stable, generally between 9%-11%.

Chart 6

Portfolio Yield And Payment-In-Kind (PIK) Income



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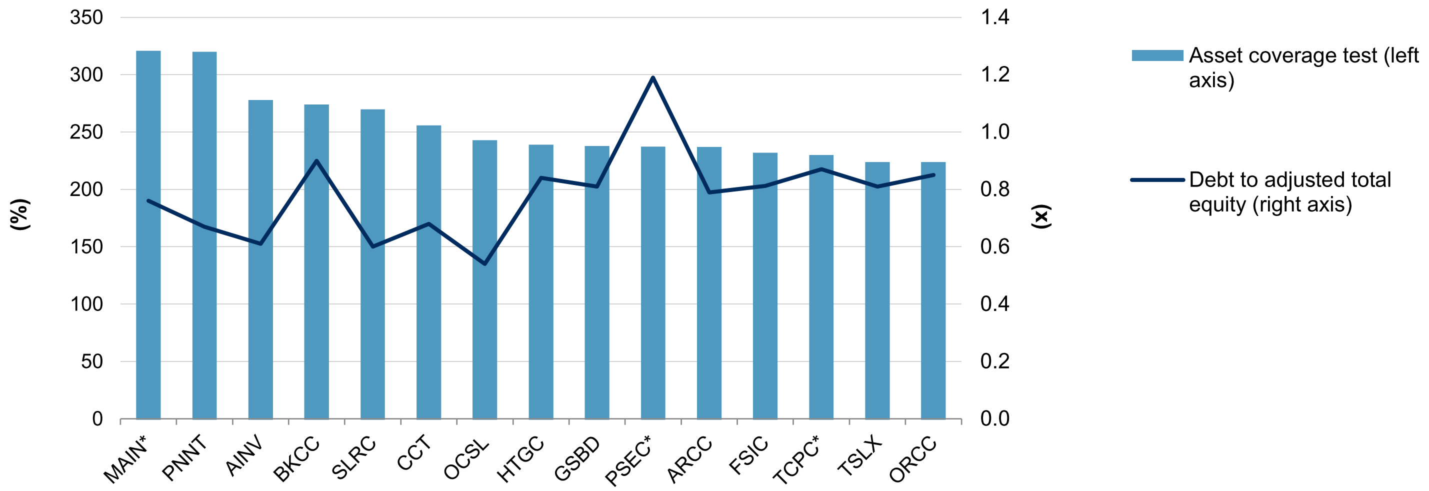
BDCs Are Displaying Very Strong Levels Of Capital...For Now

Currently, the leverage at BDCs still reflects the legacy asset coverage requirements. Under our criteria, we typically cap our rating on a BDC at 'BB+' when the cushion to its asset coverage requirement falls below about 10% (220% for the 200% asset coverage test and 165% for the 150% asset coverage test.) Six BDCs operated with asset coverage above 250% as of March 31, 2018 (see chart 7).

We also analyze leverage based on our metric of debt to adjusted total equity. We adjust the equity for unrealized appreciation/depreciation on the balance sheet (removing the fair value fluctuations) and for equity investments in leveraged finance companies, structured finance vehicles, and other lending vehicles.

Chart 7

Asset Coverage And Debt To Adjusted Total Equity



*Asset coverage is not disclosed for MAIN, TCPC, and PSEC. Based on S&P Global Ratings' estimate.
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What's To Come: More Approvals For More Leverage

We believe that as the dust settles, more companies will eventually seek and gain approval to increase leverage. We believe the additional capacity only increases supply in a market that is already extremely competitive. That said, it should take time for companies to deploy additional leverage, given the continued strong prepayment rates of underlying companies. The U.S. economy is on solid footing and has delivered strong GDP and low unemployment. Because of that economic backdrop, we do not see an immediate threat to the portfolios absent a macroeconomic shock.

This report does not constitute a rating action.