Zachary Scott
INVESTMENT BANKERS

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The Doyens of Middle-Market Leveraged Finance

Business Development Companies have emerged as non-bank lenders of choice.

by Michael T. Newsome

Since the depths of the recession in 2008, commercial borrowings have rebounded at a compounded growth rate in excess of 6%. Embedded within that growth is a small sub-sector of the credit market that is growing at a significantly faster pace - the leveraged market for acquisition and recapitalization financing.

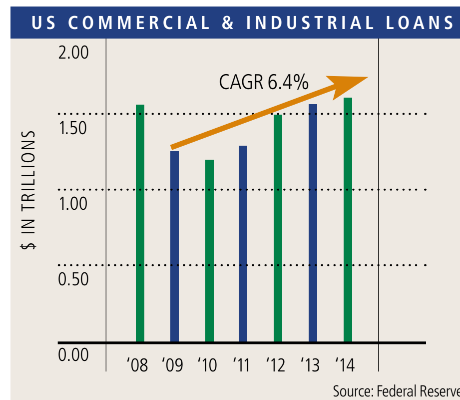
Global and large regional commercial banks, with designated cash-flow and asset based-lending units, have been a mainstay in the leveraged-loan market, particularly in the run up to the financial crisis. Regulatory tightening has made leveraged lending a more difficult proposition for banks in general, thereby changing the competitive landscape. According to S&P Capital IQ, the share of middle-market[1] leveraged loans funded by U.S. banks has slipped from more than 25% in 2009 to 9% in 2013. This erosion resulted from more stringent limits on financial leverage imposed by the Federal Reserve and the Office of the Comptroller of the Currency ("OCC") and the emergence of non-bank lenders, primarily Business Development Companies ("BDCs"), that hunt for yield without the same constraints as banks.

WHAT IS A BDC?

Congress authorized the formation of BDCs in a 1980 amendment to the *Investment Company Act of 1940*. BDCs are essentially closed-end mutual funds capitalized with equity obtained in the public market and debt from banks or bonds floated in the public debt market. BDCs are pass-through entities for tax purposes, much like a REIT, and are obliged to pay out 90% of taxable income as dividends to shareholders. Balance sheet leverage is restricted to a maximum debt to equity ratio of 1:1. In other words, a BDC can borrow a dollar for each dollar of equity held. This is far less leverage than the 10:1 ratio commonly employed by large regional and global banks.

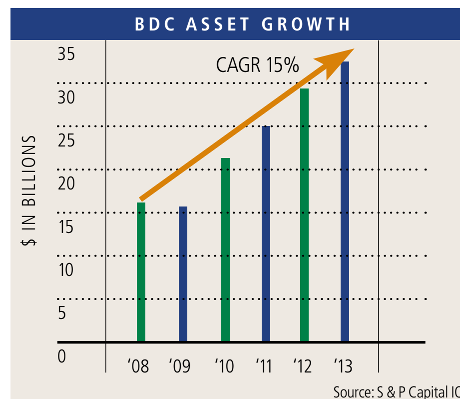
These firms have a specific mandate to facilitate capital formation for small and medium size privately held businesses. Within the aforementioned constraints, BDCs are allowed to make senior debt loans and mezzanine and equity investments, thereby providing nearly the entire capital structure.

US COMMERCIAL & INDUSTRIAL LOANS



Source: Federal Reserve

BDC ASSET GROWTH



Source: S & P Capital IQ

The concept didn't find much of a foothold for two decades. As of 2000, there were only three notable firms: American Capital, Allied Capital, and Medallion Capital. Burgeoning private-equity investment and the corresponding demand for debt capital to fund transactions has spurred development of this market. By 2008, there were 21 active BDCs and, today, there are no less than 60 firms in the market.

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Although still small in size (approximately $60BN), BDC assets have grown at a robust clip of 15% per year.

BDCs pursue a myriad of target markets and strategies. The most common objective is leveraged lending to help private-equity and strategic buyers finance acquisitions, provide growth capital, or unlock capital for shareholders via recapitalizations. While most BDCs cover a broad range of industries, we have seen the emergence of specialization – healthcare, technology, energy and natural resources, aerospace, media, alternative energy, life science, real estate, consumer products, food, agribusiness, restaurant, and specialty retail.

CREDIT APPROACH

Banks are almost exclusively senior lenders. They may originate second-lien or mezzanine loans, but the appetite to hold those assets is limited. And, of course, banks don't purposefully provide equity. So, middle-market enterprises with broader capital needs can rely on banks to provide the senior debt, but may need to scout independently (often with an intermediary) for the junior-capital components. Invariably, complexities emerge when trying to knit these capital providers together.

BDCs, on the other hand, have positioned themselves as "one-stop shops" capable of providing the entire capital structure - senior debt through control equity - either on a unitranche (blended) or a la carte basis. The pricing reflects the blending of senior, mezzanine and equity risk. A unitranche financing would be priced at a current coupon of between 6% and 16%. Depending on how deep the lender delves into the capital structure, the coupon may be coupled with warrants, options or other kickers to deliver an appropriate return.

In the current environment, credit terms are decidedly accommodative, and BDCs are no exception. Notes mature in five-to-seven years, with modest amortization requirements. Covenants are relatively light, focusing on debt service coverage. For most BDCs, collateral is not the prime consideration to deal structure. Most transactions are secured, but are acknowledged to be dependent on cash flow. As a consequence, diligence is rigorous with regard to manage-

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ment, systems and accounting quality, competitive environment, industry volatility, capital intensity and exit strategy. The lenders' diligence often piggybacks on the work of the private equity investors involved in the transaction.

BDC VS. BANK

BDCs use modest leverage, with half of their capital in the form of equity, while banks rely on deposits and short duration funds, along with a sliver of equity. As a consequence, lower

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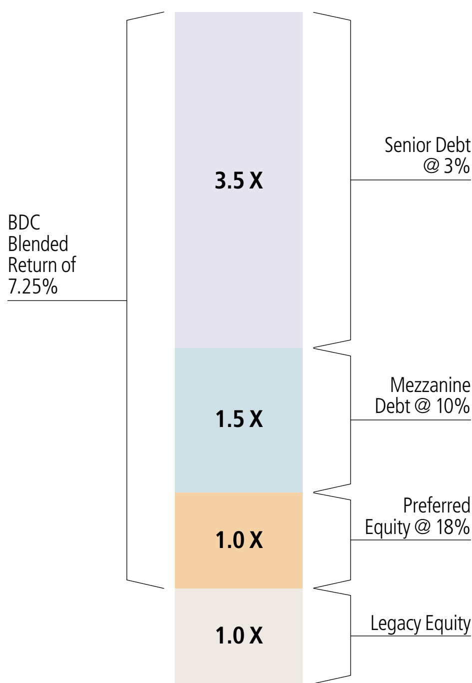
leverage combined with risk-adjusted pricing should translate into a BDC having flexibility to weather a downturn and/or exhibit patience in the face of a protracted turnaround. Under similar circumstances, a bank with the benefit of viable collateral may have an incentive to be less accommodating. Both approaches are



rational and by no means do they universally apply. Nevertheless, in the financial crisis, 454 banks went into receivership or were sold at the direction of the FDIC from 2008 through 2013. In the same timeframe, only one BDC failed - Allied Capital. This difference between bank and BDC capital structures may provide a meaningful divergence in behavior in times of stress.

BDCs will not replace banks in commercial and industrial lending. However, in the leveraged lending market they have emerged as a force to be reckoned with. BDCs offer attractive benefits in certain situations. Understanding the risk and pricing nuances and tradeoffs between a unitranche BDC option and a separately structured senior, mezzanine and equity alternative requires expertise across all of these markets as they continue to evolve. A knowledgeable advisor can be a valuable partner to determine whether a BDC is the appropriate fit in a given financing situation. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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