From Confusion Comes Clarity: An In-Depth Look at BDCs

23 October 2014
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By their very definition, business development companies are aimed to help small businesses grow. While often a hot topic for debate between devoted investors and critical eyes, the often high yields and rapid growth tend to ward off potential shareholders who worry about the process without fully understanding it.

BDC chiefs have attempted to assuage the public with as much information as possible, but the breadth of scope in these companies is always dense. The distinction between the methodologies of BDCs and banks is intricate: both compete on various markets, but, importantly, not all; and the loan terms of each differ greatly in practice.

Few financial executives have been so candid and clear on the topic as Grier Eliasek, president and COO of Prospect Capital and its flagship Prospect Capital Corporation (NASDAQ: PSEC), a giant in the BDC field. Eliasek has been lauded as a clear communicator and active proponent of clarifying the role of BDCs in today's marketplace. While some may worry about the BDCs' mixing it in with banks, the fact is that Prospect deals in higher levered deals much differently than banks, and this process is successful for both the lenders and the lent-to's alike.

Spotting the difference

Whereas a bank might offer a first-lien instrument, a non-bank entity like Prospect has the flexibility to offer a second-lien or mezzanine instrument. This is a totally different structure, split in two, wherein the BDC adopts the responsibility of the bought company after the bank takes over the first lien.

There's also a second approach, a one-stop deal—this bypasses the bank entirely, and all the term debt is handled by a BDC or other non-bank entity. Buying a company in a one-stop deal is no easy feat: the responsibility lies not just with handling the majority of equity and debt (and paying not more than is necessary, to maintain a quality yield), but also to handle the buyout in a tax-efficient manner. To under-leverage the purchased businesses would result in tax leakage for shareholders, so it's important to pay

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what's appropriate—and know what that means.

The difference deepens

When it comes to regulations that affect buyout leverage, BDCs are affected by the Office of the Comptroller of the Currency in a much different way than banks are. BDCs aim to keep buyout debt leverage under six times EBITDA. But this leverage limit is a broadly syndicated issue and depends on whether arrangers of bigger, broader deals should be capped at a given amount of leverage. Above six times, there can be an issue for both the arranger and their regulator.

In this light, BDCs and other non-bank money lenders have actually been benefiting from the increasing bank regulations we've seen in the last few years.

And yet, this is not even the market in which middle-market BDCs like Prospect Capital compete. That's what distinguishes Prospect from CLOs.

In the private-capital middle market, banks have to demonstrate to federal regulators in a five-year period that their that cash flow term loans will build up to a certain amount. Most banks are regulated at only three times EBITDA for most companies, but those middle-market companies need more leverage than that: they need to grow, recapitalize their finances, and sometimes change control entirely.

Enter the middle-market BDC. Because BDCs aren't banks, they don't accept cash deposits, instead opting for a series of low-risk, senior-secured loans. Through a series of cash sweeps and scheduled amortization, the loan is paid down on schedule and over time, which both decreases risk for the BDC and allows them to compete with banks on a higher basis-point. It's a more flexible, more secure way to dole out money.

And when it comes to base returns, public company investors prefer consistent streams of income to lump-sum capital gains, too.

Keeping taxes efficient

Prospect is always on the lookout for companies that perform well, in order to find potential exits and generate tax-efficient capital gains for investors. That's only possible by minimizing taxes for the portfolio companies.

This all hinges on not overpaying for a company. If Prospect overpaid, the debt wouldn't matter—if the company can't service the debt, there's no way around it.

"If we stick to the rules of not overpaying the companies that we're buying," says Eliasek, "and not over levering the companies that we're lending money to, that we're not buying, then we're going to be in very good shape, indeed."

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