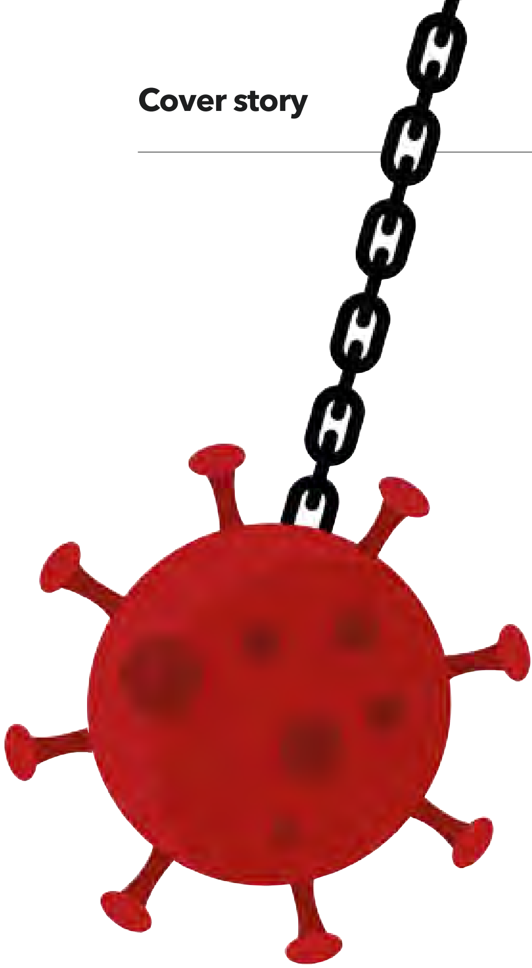


April is the cruellest month, or so said the poet TS Eliot in the years following the Spanish flu pandemic of more than a century ago. But as a novel coronavirus brings the world economy to its knees, July is likely to be the cruellest month for many of today's credit market investors. That will be when publicly traded business development companies – the closed-end funds that finance a swath of small and mid-market businesses in the US – will be reporting their second-quarter results. And these results are bound to be largely dreadful.

"If you think it's bad for BDCs now, just wait until the next quarter," says Richard Wheelahan III, founding partner of Fund Finance Partners, an advisor to asset managers. Once the 30 June reports are out, "there will be blood", says Wheelahan, who also has worked as a principal in private credit and private equity.

BDCs are expected to post significant writedowns and defaults on portfolio company loans because revenues collapsed throughout much of the economy. A decline in BDCs' net asset values could lead to them violating leverage covenants. This could cause their share prices to fall further and result in them losing their investment grade ratings. An increase in non-accrual loans could also trip other covenants under their credit facilities. This in turn would be likely to lead to dividend cuts and limit BDCs' ability to borrow.

"We have a bona fide economic catastrophe on our hands and not all of it has played out yet," says Brett Palmer, president of the Small Business Investor Alliance, a trade association for investment professionals focused on the lower mid-market. Given the enormous pressure on the small and medium-size businesses financed by BDCs, he says, "the second quarter is going to be terrifyingly ugly". Palmer likens the current economic crisis not to the events of 2008 or even to the Great Depression, but to "the year without summer" in the early 1800s, when a volcanic eruption in Indonesia caused severe climate abnormalities that resulted in major food shortages across the northern hemisphere.

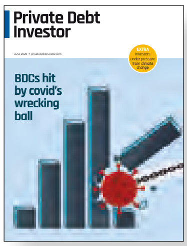
Collateral damage

Many analysts have sharply lowered their forecasts for US second-quarter GDP – JPMorgan, for example, has predicted a 40 percent decline. However, others think investors continue to underestimate the collateral damage from the extraordinary measures governments have taken to prevent widespread infection by the coronavirus and to flatten the curve of the disease's spread. These measures have brought many economies to an abrupt halt. Already, 36 million Americans have lost their jobs, and GDP in the US contracted by almost 5 percent in the first quarter, even though the effects of the pandemic had barely begun to be felt before the quarter ended on 31 March.

Major economies "will take a full decade to recover", says Carlo Besenius, chief executive of Creative Global Investments, a Luxembourg-based advisory and research firm that does private equity consulting. He expects $35 trillion to be wiped off the GDPs of the G7 economies in the next three years,

BDCs: A market that's turned ugly fast

The second quarter will be a crucial reporting period for business development companies, which target their capital at the US economic heartland of SMEs. Robin Blumenthal gets the lowdown from the market on the challenges that lie ahead



Cover story

and has even expressed concern that Europe could "fall apart". He notes that aggregate personal, corporate and government debt levels are more than 60 percent higher than they were during the 2008 crisis.

It is difficult to see how things could get much worse for BDCs, based on their recent trading. The Cliffwater BDC Index, which measures the performance of exchange-traded BDCs, plunged nearly 50 percent in March to its lowest level so far this year, though it had recovered to a negative 36 percent at the beginning of May. Still, Stephen Nesbitt, chief executive of Cliffwater, points out that the March sell-off was less steep than during the global financial crisis.

"BDCs got torched in 2008, and fell about 70-80 percent," he says, noting that people over-reacted and everything came back. "It's not as bad this time around."

In the previous crisis, he says, there was less certainty about whether the government would intervene, whereas this time there has been no hesitation: "The government has said, 'We'll do whatever is necessary.'"

Moreover, BDCs have become much larger since the last crisis, with gross assets skyrocketing from just $19 billion in 2009 to $113 billion in 2019. "From that perspective, the business models and balance sheets are more resilient," says Christopher York, an industry analyst at JMP Securities.

Increasing leverage

But BDCs, which stepped into the breach to fund riskier companies after regulators forced banks to tighten their lending standards following the last crisis, have been largely excluded from the massive regulatory relief being pumped into the financial system.

At the same time, many funds have been increasing leverage over the past few years with the blessing of Congress, which in 2018 doubled BDCs' allowable debt-to-equity ratios to 2-1. The uncertainty about the duration and extent of the economic lockdown makes for little visibility into second-quarter revenues and earnings.

"We are in uncharted waters when it comes to projecting company performance," says Ted Koenig, president and chief executive of Monroe Capital, a direct lender and BDC manager with around $9.3 billion under management.

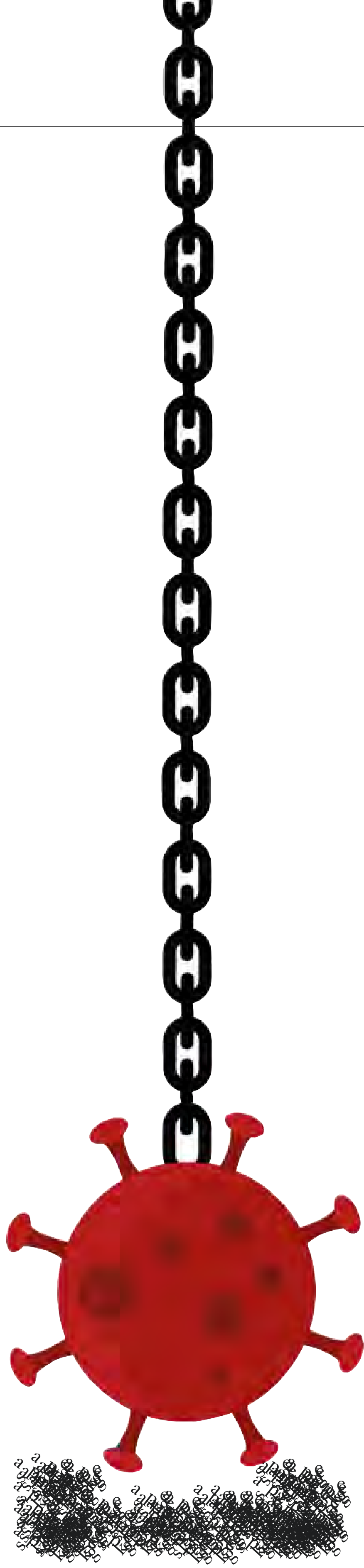
One thing does seem clear, however. In the second quarter "we are going to start to see real fundamental deterioration", says Ryan Lynch, an industry analyst at KBW, as specific investments are marked down. He says that in the first quarter, liquid loans were already written down by 10.7 percent on average, thus reflecting significant risks in the credit markets.

Given that many businesses saw 90 percent of their revenues disappear in the first quarter, Lynch is expecting a substantial increase in losses and defaults in the second, as portfolio companies miss their debt payments. The longer the economic crisis continues, the greater the possibility that even those credits that are still managing to pay interest in the second quarter will eventually default.

Any pressure on net asset values could trigger debt covenants, which would increase the potential for defaults. Capitala Finance Corp, a small BDC with an investment portfolio of $321 million, suspended its second-quarter dividend in early May after reporting that per-share NAV had plunged by 31 percent between Q4 of 2019 and Q1 of 2020. Declines in credit quality led to a default under its credit facility, thereby cutting off access to its line of credit. As of 31 March, the debt of eight of Capitala's 41 portfolio companies was on non-accrual status.

Dividends, one of the principal attractions of BDCs for retail investors, are at risk. Lynch of KBW expects BDCs to reduce dividends by an average of 20 percent over the next two years. Golub Capital has cut its quarterly dividend by 12 percent and Gladstone Capital Corp has lowered its monthly payout by 7 percent. Main Street Capital recommended halting its biannual supplemental dividend.

"We are in an environment where meaningful credit losses are expected," Lynch wrote in a report in late March. He predicted "a significant spike in



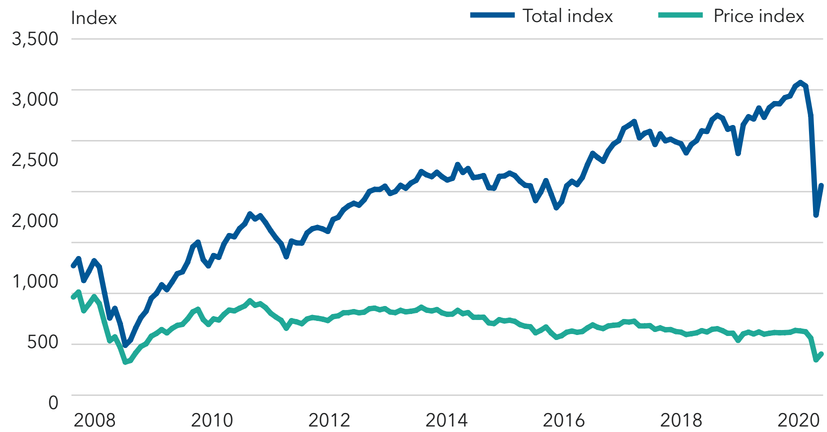
> *"We have a bona fide economic catastrophe on our hands and not all of it has played out yet"*
>
> **BRETT PALMER**
> **Small Business Investor Alliance**

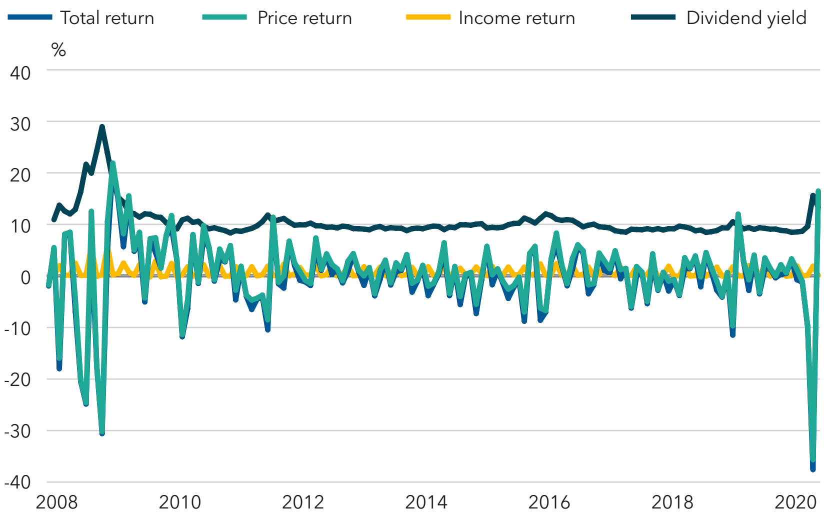
non-accruals" starting in the second quarter. Before BDCs began announcing their first-quarter earnings in early May, Lynch was expecting them to report NAV declines of 10-20 percent for the period, though he had not issued any forecasts on declines for the second quarter.

York of JMP Securities was predicting that NAVs would decline by between 7 percent and 35 percent for the first quarter. Consequently, he expects to see more equity issues or rights offerings in the second and third quarters, akin to those announced in the past two months by Bain Capital and Golub Capital. Amid the pandemic's economic repercussions, Bain cited the need to help the company navigate "the uncertain and volatile" periods ahead. Golub spoke of fortifying its balance sheet, as well as positioning it to take advantage of opportunities resulting from the crisis.

Ares Capital, the largest BDC with $15.8 billion under management, said

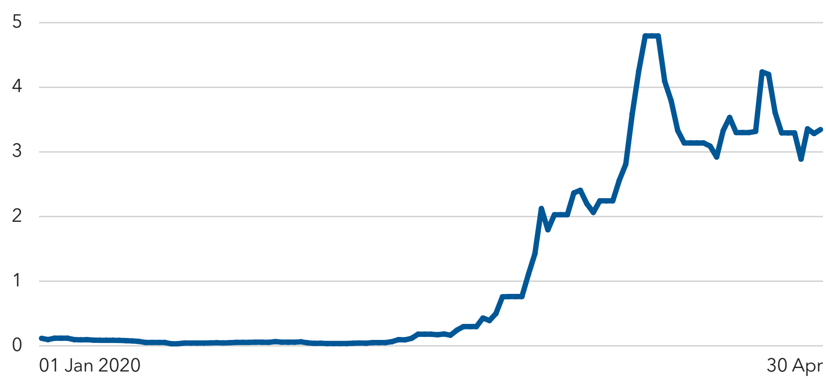
Cliffwater's latest data show BDCs sustaining their biggest declines in value since the financial crisis





Source: Cliffwater

Median probability of default among BDCs (%)



Source: S&P Global Market Intelligence

on its earnings call that it was well positioned to be opportunistic in buying companies at a significant discount to fair value, once the smoke had cleared. Although it reported that its first-quarter net asset value had declined 10 percent, Ares maintained its dividend.

Chief executive Kipp deVeer said it had a "tremendous amount of liquidity" to support its portfolio companies. In addition to its $2.1 billion of liquidity, Ares said private equity sponsors could provide support if needed. DeVeer noted that although he expected the second quarter to be an ongoing challenge, there were "no material changes" in interest payments in April.

Meanwhile, Ares is maintaining close communication with private equity sponsors and borrowers on a weekly, if not daily, basis.

But not every BDC has such a significant cushion. "Everything I've seen and heard is that BDCs and private equity firms are having to triage and decide which portfolio companies are viable," says Robert Gayda, a partner in the corporate restructuring and bankruptcy group at law firm Seward & Kissel. Moreover, "the spigot has turned off" in lending to private equity shops and BDCs themselves, which are starting to turn to alternative financing such as factoring and asset-based loans.

Given the uncertainty about the duration and depth of the economic stoppage, many BDC portfolio companies are already hoarding cash, slashing expenses and delaying payments as much as possible, according to Palmer of the SBIA. These smaller companies are much more sensitive to volatility, and do not maintain huge liquidity reserves. Consequently, "a lot of managers are going to have to face really hard decisions", Gayda says.

"The biggest challenge is that companies need liquidity to get through the next three to six months," says Bob Bartell, global head of corporate finance at Duff & Phelps. "There is

Top 10 BDCs

	Share price* ($)	Market capitalisation ($m)	% of 52-week high	Price/book multiple
Ares Capital Corporation	13.10	5,536	67.8	0.84
Owl Rock Capital Corporation	12.28	4,713	64.0	0.87
Main Street Capital Corporation	27.25	1,768	60.4	1.31
Prospect Capital Corporation	4.46	1,647	65.0	0.55
FS KKR Capital Corporation	3.19	1,579	50.0	0.52
Golub Capital BDC	10.66	1,426	55.7	0.73
TPG Specialty Lending	17.01	1,141	71.9	1.09
Hercules Capital	10.33	1,134	63.0	1.03
New Mountain Finance Corporation	8.04	778	55.6	0.72
Solar Capital	14.68	620	68.8	0.76

Sources: company and stock exchange reports, compiled by Duff & Phelps *as of 28 April

definitely going to be a short-term pause with abrupt and severe actions. No one is even able to transact."

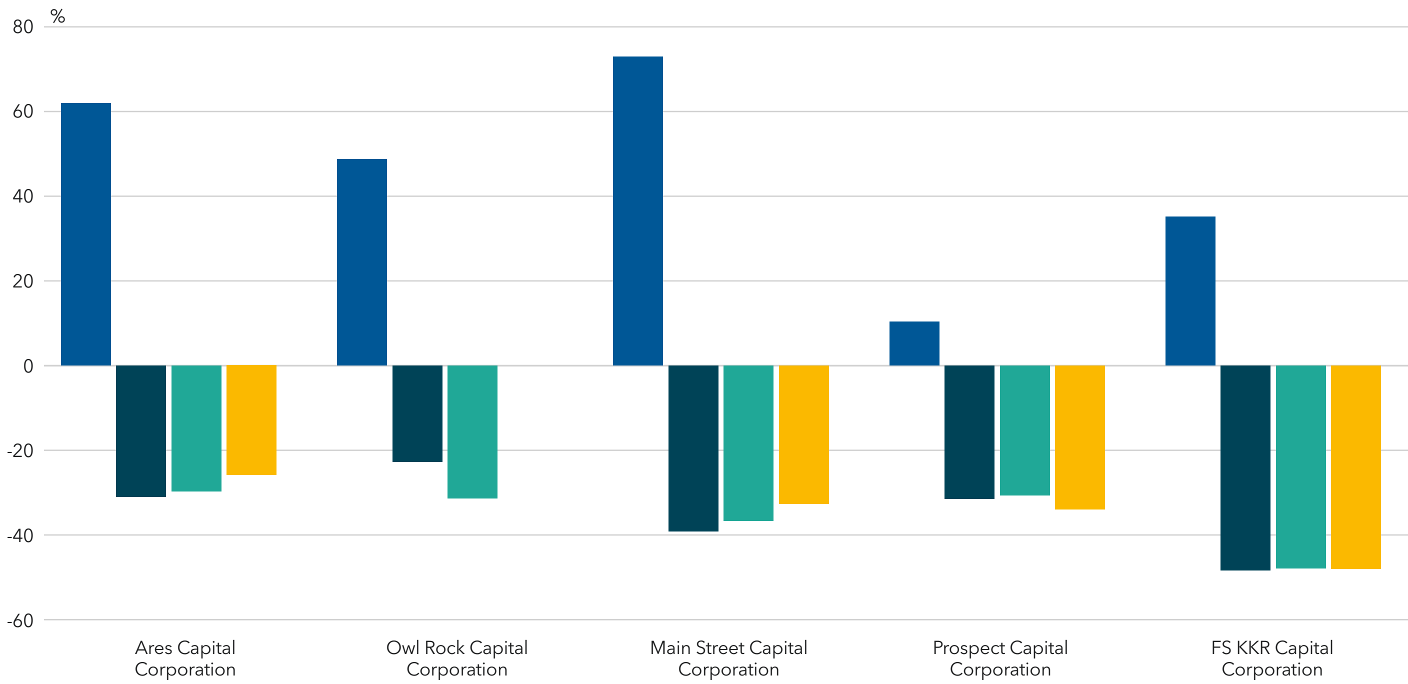
Not full marks

Because managers often use transactions to help value their portfolio companies, the hiatus in the M&A market increases the difficulty of marking assets.

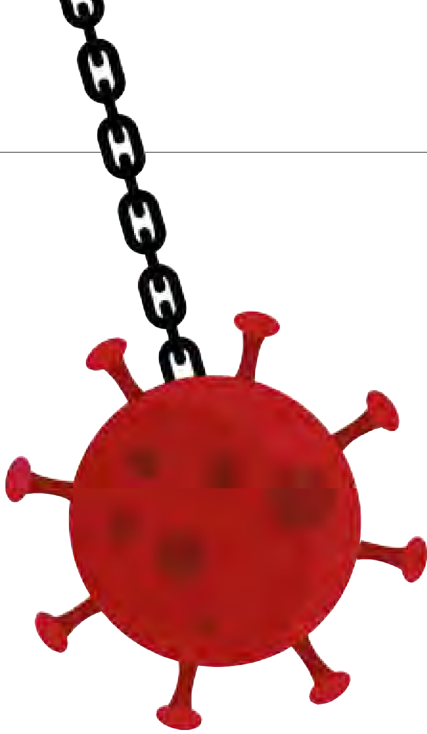
"With the economy being shut down for a big chunk of the quarter, we know that the numbers will generally be soft but we don't know what the mark to market will be," says Art Penn, founder and managing partner of PennantPark Investment Advisers, a mid-market credit platform with two BDCs and a variety of private vehicles.

Given that each of the underlying companies has its own capital structure, he says the analysis is "like looking at fingerprints or snowflakes. Each one is different". Moreover, because government-imposed lockdowns have

Although the top BDCs have posted growth since April, their performance over the past year has been less impressive



Source: Duff & Phelps



shuttered a substantial part of US small business, "there is no good visibility into revenues and earnings for some companies for the next six months", says Koenig of Monroe Capital. Consequently, banks are going to be very cautious in providing credit to companies.

Those BDCs with a tilt towards sectors that are most exposed to pandemic-related issues, such as travel and leisure, energy and transport, could find themselves in tighter straits than those that invested in healthcare and technology.

And funds with substantial stakes in sectors such as retail, which were problematic even before the pandemic, or which had been serial underperformers for some time, "may be in dire liquidity or capital market situations after the fallout from the crisis", says Wheelahan of Fund Finance Partners. He says the market has already identified five or six viable takeover candidates. He adds that even some of the better performers, which face a confluence of tight liquidity positions and substantial unfunded commitments from portfolio companies, could be under significant pressure.

Fitch Ratings, which has maintained a negative outlook on the BDC sector for several years, downgraded the ratings of BlackRock Capital Investment Corp in early April, after placing it and New Mountain Finance Corp on ratings watch negative.

Later that month, citing heightened challenges from the pandemic, Fitch revised the outlooks on five BDCs – Ares Capital, BlackRock TCP Capital, FS KKR Capital, Goldman Sachs BDC and Oaktree Specialty Lending – from stable to negative.

Data from S&P Global Market Intelligence show that the probability of default among 61 publicly traded BDCs spiked in March to nearly 4.8 percent after hovering near zero until the end of February, although the rate has since recovered somewhat.

Once the fog clears, there will undoubtedly be opportunities to buy assets at a deep discount.

Until then, "sadly, there will be a credit crunch", says Wheelahan. "But there will be a quick recovery when the economy finally does come back."