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EXTRA CREDIT

ARE BDCS, SBICS OR SOME HYBRID OF BOTH THE ANSWER TO FINANCING A STRAPPED MIDDLE MARKET?

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THE RECENT TURMOIL throughout the credit markets has raised some fundamental questions regarding who will provide access to capital for middle-market companies. The public equity markets have now emerged as a viable option for lenders who finance middle-market companies. Specifically, both the program for small business investment companies managed by the Small Business Administration and the business development company model have emerged as attractive potential alternatives.

The BDC model may represent one possible solution to restart middle-market lending and make credit available once again to the types of middle-market companies that frequently serve as catalysts for the overall U.S. economy. The BDC industry has provided a steady source of lending to the middle market for the past decade and accounted for more than half of all mezzanine lending in the U.S. during 2008, even though only about 25 BDCs are publicly traded. In addition, the portfolio companies in which the BDC industry invested during 2008 represented more than one million jobs throughout the U.S.

While the BDC industry has faced the same market pressures as other financial industry participants during the current crisis, including fluctuating share prices and increased pressure to de-lever balance sheets, the industry has enjoyed an aggregate market capitalization of more than \$21 billion in recent years. The BDC industry has also recently enjoyed renewed access to the public equity markets, having raised more than \$560 million in follow-on offerings over the past four months. In addition, several initial public offerings for potential new BDCs are pending, including THL Credit Inc., which may raise up to \$300 million.

BDCs are considered "closed-end" investment companies, are generally publicly traded and typically focus on debt investments in primarily middle-market, nonpublic, U.S.-based companies. BDCs are unique in that they are subject to many, but not all, of the provisions of the Investment Company Act of 1940, applicable to registered closed-end funds while also being subject to the governance and reporting requirements of the Securities Exchange Act of 1934, or the Exchange Act, applicable to typical operating companies. The BDC model is much more reasonably leveraged, at a 1-to-1 debt-to-

equity ratio, and regulated more than some of the other specialty finance companies that have faced significantly greater struggles during the economic crisis.

The ability to raise public capital provides the BDC model with an advantage over traditional private equity funds. Unlike traditional PE funds, there are no minimum income, net worth, or sophistication requirements for investors in a BDC. Also, BDCs have been frequent issuers in the public markets, while it could take a PE fund months to raise similar capital. It is likely that the time lag faced by PE funds may grow while the credit markets remain tight.

Many funds will likely have to finance further growth through the issuance of additional equity while credit markets remain largely closed; however, many of the institutional investors that have in the past generally been willing to participate as limited partners in PE funds are hesitant to return to financing middle-market lending activities. BDCs, on the other hand, provide investors with the liquidity found in any other publicly traded investments while also giving BDC managers access to a permanent source of capital in the public equity markets.

SBICs may be another possible solution to make credit available once again to middle-market companies. Six BDCs have formed SBICs as a potential reliable funding source through the Small Business Administration, including Hercules Technology Growth Capital Inc., Main Street Capital Corp., MCG Capital Corp. and Triangle Capital Corp. BDCs with SBIC-licensed subsidiaries have access to the SBA's debenture program. The SBIC program has become even more attractive as a result of new legislation increasing the amount of leverage that an SBIC may borrow from the SBA.

Two of the more recent business development company initial public offerings involved conversions of SBICs into BDCs, including Main Street Capital and Triangle Capital.

In addition, other BDCs are considering creating SBIC subsidiaries to access the SBA's debenture funding. Interestingly, the BDCs that have an SBIC subsidiary have traded better than other BDCs during the economic crisis. Between a BDC's ability to raise public capital and an SBIC's access to SBA debentures, the BDC-SBIC model appears to be an attractive and reliable source of funding for mezzanine and debt funds. ■

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