17th Annual BDC Roundtable
September 4-5, 2019
JW Marriott Washington, DC

hosted by EVERSHEDS SUTHERLAND

Recapping the 2019 BDC Roundtable
About the 17th annual BDC Roundtable

On September 4-5, 2019, Eversheds Sutherland and the Small Business Investor Alliance (SBIA) hosted the 17th annual BDC Roundtable in Washington DC. Widely acknowledged as the premier industry event, over 300 representatives of issuers and their service providers heard presentations from 15 panels that included senior management from the largest BDCs, investment banks, accounting firms, valuation consultants and shareholder participation organizations, as well as a number of senior officials from the SEC. This brief recap of the topic areas discussed at the event includes live audience polling results.
2019 BDC Roundtable by the numbers

>70% BDCs represented

350+ registrants

50 speakers

40 sponsors

15 panels

7 regulators
Industry hot topics

We are nearing the end of the credit cycle and seeing slowed growth, but continued low unemployment. The potential economic risks include slowing global output and trade uncertainty. Overall, the BDC industry appears to be better prepared for a recession than the industry was for the 2007 economic crisis. Balance sheets are less risky as there is much more diversification of assets and liabilities. Additionally, commentatores observed that BDCs appear to be more selective in deal-making, and are not just “chasing deals.” The leverage increase has had a limited impact on BDCs debt capital markets because BDCs are waiting for information from rating agencies on the potential impacts of increased leverage. Regarding Valuation, the panelists and attendees agreed that quarterly third-party valuations are most common in the industry. Additionally, there were mixed reactions to the operational and logistic valuation effects as a result of the planned discontinuation of LIBOR in 2021.

How do you see the BDC industry developing over the next few years?

- Rapid growth 13%
- Moderate growth 38%
- Consolidation through strategic transactions 47%
- Let me get back to you after the conference! 3%

What do you expect from BDCs in the next 10 years?

- More BDCs, greater collective AUM 39%
- Fewer BDCs, greater collective AUM 57%
- More BDCs, lower collective AUM 3%
- Fewer BDCs, lower collective AUM 1%

What are the best practices when it comes to frequency of third-party valuations?

- Monthly 2%
- Quarterly 94%
- Semi-annually 4%

“The event itself continues to attract the biggest organizations in the space.”
Co-investment

The 1940 Act prohibits “joint transactions” between BDCs and certain affiliates, and therefore BDCs seeking to co-invest in issuers with other funds on their platform typically file an application with the SEC to obtain an exemptive order to permit such co-investments. There are two main models for applications seeking co-investment relief, and each model contains certain similar enumerated “conditions” detailing the requirements for completing co-investments transactions. Because they are specific, the conditions, which are meant to protect the BDC, can at times still prohibit certain co-investment transactions that may be in the BDC’s best interest. A new form of co-investment application with conditions that depart significantly from the current approved conditions has been filed with the SEC. That application removes the most stringent prohibitions of the existing models and places a greater emphasis on the fiduciary duties of investment advisers. While it is uncertain when, if, and in what form, this new model will be approved by the SEC, as drafted, it would address many of the issues BDC platforms face under their current co-investment orders.

“The BDC Roundtable brings us together to share knowledge and shape the future of the BDC industry.”

“People have spoken a lot about all of the practices and standards this conference has helped to improve.”
Offering reform, accounting and valuation

In March of 2019, the SEC released proposed offering reform rules that will grant BDCs access to capital markets where previously BDCs were explicitly excluded. A significant number of the comment letters submitted by industry participants advocated expanding the definition of a well-known seasoned issuer (WKSI) and/or providing alternatives for calculating public float. The offering reform rules also require BDCs to begin implementing financial tagging via Inline XBRL, which will be required for all filings beginning in 2021.

On the accounting side, issuers should be aware that critical audit matters (CAMs) are effective now for large accelerated filers; auditors have been preparing but management should also begin examining potential disclosure. One of the biggest accounting issues BDCs face today is the issue of significant subsidiary reporting under Regulation S-X. Rulemaking will likely change the income test to simplify the test and make it more consistent. There also is a desire within the industry that the SEC will eventually eliminate the income test altogether in favor of the assets test. As related to taxes, a 20% deduction of qualified business income as a domestic flow-through entity can pass on to investor shareholders to deduct 20% from taxable income. BDCs are not currently eligible for the section 199(a) dividend form, to pass on qualified business income. Within Offering Reform, REITs were extended the option to use 199(a), and BDCs are advocating for that benefit as well.

Issuers should also be preparing for the elimination of LIBOR in 2021, particularly for agreements that extend beyond 2021, and companies should be prepared to discuss and disclose their transition plans.

The regulatory environment

The SEC hopes to continue to partner with the BDC industry and further develop the core body of knowledge that resides in the Division of Investment Management. The Staff acknowledged a few particular areas in the space that are being addressed, including the exemptive relief process, AFFE rules and strategic transactions. When interacting with regulated entities, the SEC prefers an environment where questions are asked, and there is an open line of communication between regulated entities and the SEC. For example, the recent offering reform rulemaking process has been a consultative process, where the rulemakers have received comments and feedback both formally via comment letters and informally via telephone calls. SEC rulemakers emphasize the importance of also providing comments about provisions of rule proposals, as these comments can provide the SEC with practical information against other commenters who may not be in favor of any given proposal.

Of which elements of the BDC offering reform have you taken advantage?

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<th>Element</th>
<th>Percentage</th>
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<tr>
<td>Forward incorporation by reference</td>
<td>17%</td>
</tr>
<tr>
<td>Short-form registration statement on Form N-2</td>
<td>50%</td>
</tr>
<tr>
<td>Qualification as a WKSI</td>
<td>17%</td>
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<tr>
<td>Communication rules</td>
<td>17%</td>
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What is the expected impact of offering reform?

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<th>Impact</th>
<th>Percentage</th>
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<tr>
<td>More BDCs, greater collective AUM</td>
<td>5%</td>
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<tr>
<td>Fewer BDCs, greater collective AUM</td>
<td>58%</td>
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<tr>
<td>More BDCs, lower collective AUM</td>
<td>37%</td>
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<td>Fewer BDCs, lower collective AUMz</td>
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Legislative developments

The AFFE rule addressing the disclosure of fees and expenses remains a major issue for traded BDCs. It negatively affects shareholders, as according to Brett Palmer, President of the SBIA, it led to a 13% drop in BDC market activity. He also stated that it can lead to an inaccurate depiction of BDCs which is making raising capital more difficult for the industry. Additionally, SBIA and issuers have been working closely with Congress to weigh in with the SEC. Many congressional members consider this the AFFE rule a priority and are calling on the SEC to address this and other issues that will increase access capital. One group has filed an exemptive application to address the issue. SBIA is also engaged with the Congressional tax writing committees on legislation to restore tax parity for BDCs. The Tax Cuts and Jobs Act allows for a 20% pass-through deduction for REITs and S-Corp shareholders that should also be extended to BDCs.

If AFFE reform occurs, will BDCs be placed back into the indices?

| Yes       | 69% |
| No        | 3%  |
| Maybe     | 28% |

“It’s really the only time that ordinary people in the industry have a chance to hear, personally, the views of the SEC.”

“The SBIA and Eversheds Sutherland will be able to take away the exact regulatory and legislative needs of the constituency...”
Private BDCs

Fundraising
Private BDCs are subject to a variety of requirements relating to fundraising and marketing—and fundraising questions come up on a regular basis from Private BDC managers. For example, there are a variety of timing implications that come into play regarding the interplay of accepting money from investors, electing to be regulated as a BDC, and obtaining favorable RIC tax status. Also, private BDCs are subject to plan asset limitations under ERISA rules, which forces managers to think about ways to satisfy those limitations when accepting money from pension plans and other investors subject to ERISA, including potentially taking advantage of the Venture Capital Operating Company (VCOC) exemptions or securing enough commitments from other sources. Private BDC managers also have to satisfy certain additional requirements when fundraising internationally, including disclosure requirements and the requirement to engage a placement agent in certain jurisdictions. International fundraising also often prompts questions on the favorable RIC tax treatment and how it is helpful to individual non-US investors.

What’s next?
BDCs that offer their shares through the private placement structure are known as Private BDCs and are considered to be a hybrid between a private fund and a traditional BDC. Many Private BDC organizational documents provide that the Private BDC must conduct a liquidity event within a set period of time (usually five to seven years after its launch). As a result of the recent popularity of Private BDCs, at least 12 Private BDCs are currently expected to have a liquidity event within the next six years. Liquidity events could include a merger (either with an affiliate or an unaffiliated third party), exchange listing (either in connection with a public offering or as a direct listing) or a spin-off. In some instances, the Private BDC’s organizational documents specify the liquidity event, and in others, it is left to the Private BDC’s board. In all instances, the Private BDC’s board generally has discretion to determine the timing of the liquidity event (generally taking into account market conditions) within the parameters set out in the organizational documents. Private BDCs anticipating a liquidity event should begin preparing in advance and consider, among other things, whether they will need to obtain lock-up agreements from existing shareholders, whether there are any advantages to offering existing shareholders registration rights and whether existing documents have any provisions that will spring into effect following a liquidity event and whether existing documents have any termination penalties or prohibitions on assignment in connection with a merger.
Leverage and asset coverage

Most listed BDCs have taken action under the Small Business Credit Availability Act to opt into the reduced asset coverage ratio and, as a result, are now subject to an asset coverage ratio of 150% (instead of 200%) for regulatory purposes. Most of those BDCs have also engaged with their credit-facility providers, with varying results, to negotiate modifications to their asset-coverage-ratio maintenance covenants so as to allow for increased leverage in light of the reduced statutory asset coverage ratio. In many cases, increased covenant flexibility has been accompanied by other facility modifications to mitigate the risks of additional leverage, such as the addition of separate senior-debt coverage-ratio requirements and/or borrowing-base and portfolio-composition constraints that tighten or require a more senior portfolio as leverage increases. As BDCs increase their leverage, market participants should expect increased volatility and increased expected returns. Debt capital markets are generally open. Baby bond issuances are down from 2018 while institutional debt offerings are up. The institutional community has become more open to participating in debt issuances that are not index eligible. Most baby bond issuances are now rated. Other financing trends in 2019 that may become more common: BDC balance-sheet CLOs (and warehouse SPV facilities to facilitate those CLOs). LIBOR transition is an important issue for BDCs to assess and address on both the asset and liability side of their business as they prepare for the expected cessation of LIBOR reporting after 2021.

A year from now, what do you expect to be the average BDC target debt-to-equity ratio?

- Rapid growth: 13%
- Moderate growth: 38%
- Consolidation through strategic transactions: 47%
- Let me get back to you after the conference! 3%

Do you all expect to see the increased use of BDC CLOs and SPV warehouse facilities?

- Yes, increase in BDC CLOs: 22%
- Yes, increase in BDC CLOs combined with SPV warehouse facilities: 49%
- No, no significant increase, just a continuation of past financing structures: 30%

“It’s really great to come to this event to hear the different perspectives and insight. And to really just learn from people in the industry.”
Strategic transactions and shareholder activism

There has been an increasing number of strategic transactions in the BDC space. While in the strategic transaction phase, management and board considerations include fiduciary duties, special committees and the Investment Company Act of 1940. There has been an overall increase in shareholder activism in the BDC and closed-end fund space recently. For managers of BDCs and other funds, the best offense is to ensure that the shareholder base is solid, including long-term strategic planning and risk management by management and the board. Maintain a strong governance structure, including a properly functioning and truly independent board. Most importantly, management and the board should be communicating on an ongoing basis with all shareholders.

How concerned are you about an activist investor targeting your BDC?

- Welcome to my recurring nightmare 27%
- Sometimes it keeps me awake 18%
- Slightly worried 36%
- Which panel is next? 18%

“Participants of the conference leave feeling as though they are very current with what’s going on with our regulators and they have benefited from all of the networking.”
BDC industry outlook

Industry leaders opined about the BDC structure and the industry as a whole. Accordingly, the BDC structure is shareholder and borrower-friendly, and the industry overall will continue to see good growth. The industry outlook is very positive with direct lending continuing to take market share from the public markets. They are excited about continued institutionalization of the management side. Their advice to other managers—be transparent, be forthcoming with what you plan to do, then follow through on that plan. Also, just because it hasn’t been done, doesn’t mean it can’t be done. Continue to innovate within the industry.

“As the substance of the BDC world expands and becomes more nuanced, I find the conference addresses those issues in a more nuanced way.”

Event presentations, program materials and highlights may be accessed at www.publiclytradedprivateequity.com/BDCRoundtable.
Thank you to our speakers

Cynthia Beyea, Partner, Eversheds Sutherland
Joshua Bloomstein, Vice President; General Counsel and Secretary, Ares Capital Corporation
Steven Boehm, Partner, Eversheds Sutherland
Vlad M. Bulkin, Partner, Eversheds Sutherland
Kristin Hesper Burns, Partner, Eversheds Sutherland
Joseph Caruso, Chief Operating Officer & Co-Founder, Alliance Advisors
Paul Cellupica, Deputy Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission
R. Kipp deVeer, Director and Chief Executive Officer, Ares Capital Corporation
Dwaune Dupree, Associate, Eversheds Sutherland
Joshua Easterly, Chief Executive Officer, Chairman of the Board, TPG Specialty Lending, Inc.
Jaime Eichen, Partner, Financial Services Professional Practice, Ernst & Young LLP
Patrick Frisch, Managing Director – Head of IIF, ING Capital, LLC
Michael Gerber, Senior Managing Director, Corporate Affairs, FS Investments
Matthew Giordano, Deputy Lead Partner – Public Investment Management, KPMG LLP
Cristiano Guerra, Head of ISS Special Situations Research, ISS
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Alan Kirshenbaum, Chief Operating Officer & Chief Financial Officer, Owl Rock Capital Corporation
John Kline, Managing Director, New Mountain Capital
Jacob Krawitz, Branch Chief, Division of Investment Management, U.S. Securities and Exchange Commission
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Cindy Ma, Managing Director, Houlihan Lokey
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Brett Palmer, President, Small Business Investor Alliance
Laurence Paredes, General Counsel and Corporate Secretary, BlackRock Capital Investment Corporation
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Jay Williamson, Senior Counsel, Division of Investment Management, U.S. Securities and Exchange Commission
Scott Winter, Managing Director, Innisfree M&A Incorporated
Jon Yoder, Managing Director, Chief Operating Officer, Goldman Sachs BDC, Inc.

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