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The Growth of Private BDCs

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The Huge Growth of Private Credit

This article discusses the continued interest in privately offered business development companies (BDCs) among private credit managers.

Since 2003, bank lenders' involvement in sponsored middle market transactions has fallen from approximately 70 percent to 20 percent of the market.[1] This has created an attractive opportunity for alternative, non-bank lenders to step into the gap and provide private financing to these companies at attractive interest rates. The private credit/direct lending business has grown rapidly since the financial crisis. As of December 31, 2017, private credit had more than $420 billion of committed capital, with an additional $246 billion of investible cash available. This represents a massive growth in private credit from 2007 in which only $107.1 billion of capital had been committed, with only $99.7 billion in available cash for investment.[2]

A large component of the growth in the private credit industry has come from BDCs. BDCs are a specialized type of investment product that have increased regulatory flexibility as compared to registered investment companies and that have superior tax characteristics and liquidity options as compared to traditional private credit funds that engage in direct lending.

The key aspects of a BDC can be summarized as follows:

- A BDC must invest at least 70 percent of its total assets in US private operating companies (or very small US public companies).
- A BDC is a corporation for US federal income tax purposes, but pays no entity level tax. As a result, a BDC is a very efficient tax blocker for a US direct lending strategy – a BDC blocks ECI and UBTI for non-US and US tax exempt investors.
- A BDC can borrow up to 2:1 (debt to equity) to employ its direct lending strategy.
- A BDC has more flexibility to engage in certain affiliated transactions than mutual funds and closed-end funds.
- A BDC is subject to many provisions of the Investment Company Act of 1940, as amended, (1940 Act) but is subject to the more complex reporting requirements of the Securities Exchange Act of 1934, as amended (1934 Act).
- A BDC typically pays its investment adviser a 1.5 percent-2.0 percent management fee on gross assets and a 15 percent-20 percent performance fee on income and net realized capital gains

Below we provide a detailed discussion of the basics of BDCs. We focus particularly on the benefits and characteristics of privately offered BDCs, which a number of prominent private credit managers have launched in recent years and which provide a number of distinct benefits as compared to traditional publicly offered listed BDCs.

Because of their unique offering characteristics and tax status, private BDCs are a flexible way for private credit managers with a direct lending business to attract a wide variety of US and foreign institutional investors and to maintain the funds raised in a permanent capital vehicle.

The ABCs of BDCs

Origin and Business

In 1980, Congress enacted the Small Business Investment Incentive Act, which, among other things, created a statutory framework for BDCs. BDCs were originally envisioned as a type of publicly offered private equity or venture capital vehicle that would make control equity investments in, and provide managerial assistance to, US small- and middle-market companies. However, despite the initial intent of Congress, BDCs have historically been income-generating products that have focused on directly originated loans to US small- and middle-market companies.

Qualifying Assets

Pursuant to Section 55 of the 1940 Act, at least 70 percent of a BDC's total assets are required to be in investments meeting the requirements of Section 55(a)(1)-(6) (qualifying assets). Qualifying assets generally include debt or equity investments in US private issuers or very small US public companies (those with a market capitalization of less than $250 million). The 70-percent test is an incurrence test and must be tested each time that the BDC would like to make an investment into a non-qualifying asset. Passive breaches of the 70-percent limit are not a regulatory violation but will preclude the BDC from making further investments into non-qualifying assets until the ratio is set back in order. Most BDCs use the 30-percent basket for loans to non-US companies. Investments in registered investment companies, private funds,[3] and other BDCs are also not qualifying assets.

Tax Benefits

A direct lending strategy will likely give rise to income that is effectively connected to a US trade or business (ECI). Further, because originated loans may be viewed as a business, this strategy will give rise to unrelated business taxable income (UBTI).[4] However, BDCs are eligible to make an election to be treated as a regulated investment company (RIC), and accordingly, they are able to cleanly block both ECI, which is problematic for non-US investors, and unrelated business taxable income UBTI, which presents issues for US tax-exempt investors.

As discussed below, this accordingly makes BDCs very attractive investments for foreign and tax-exempt US investors that wish to gain exposure to a leveraged US direct lending strategy. Additionally, as a RIC, BDCs issue 1099s to their investors rather than K-1s.

Finally, pursuant to the Protecting Americans from Tax Hikes Act of 2015, Congress has made permanent special withholding rules applicable to RICs. Specifically, certain properly designated dividends are generally exempt from withholding of US federal income tax where they are paid in respect of a RIC's (1) "qualified net interest income"[5] or (2) "qualified short-term capital gains".[6]

Leverage Limits

Like registered investment companies, BDCs are subject to leverage limits under the 1940 Act. As a default matter, BDCs may issue senior securities (debt or equity) so long as their "asset coverage ratio" does not fall below 200 percent. An asset coverage ratio is defined by Section 18 of the 1940 Act, which is made applicable to BDCs through Section 61, as, "…the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer." Accordingly, a 200 percent asset coverage ratio allows BDCs to maintain a maximum debt to equity ratio of 1:1 (that is, $100

of equity, with $100 of debt, creates total assets of $200, and a total assets to debt ratio of 200 percent).

In 2018, Congress enacted the Small Business Credit Availability Act, which, subject to certain conditions[7], allows the option for BDCs to increase their leverage limits through lowering their asset coverage ratio to 150 percent. This would allow for a debt to equity ratio of 2:1 (that is, $50 of equity with $100 of debt creates total assets of $150, and a total assets to debt ratio of 150 percent).

A number of prominent private credit managers, including Bain, Golub, and Goldman Sachs, have also enhanced their BDCs' ability to employ leverage through the use of unconsolidated joint venture subsidiaries. Through use of these joint venture entities, BDCs are able to incur off-balance-sheet leverage that is not included for the purposes of calculating the BDC's asset coverage ratio. In order to qualify for the unconsolidated accounting treatment, among other things, the joint venture entity must be a true joint venture, equally controlled by the BDC and its JV partner, and, in particular, all investment decisions must be jointly agreed to.

Regulatory Requirements

BDCs are subject to a significant portion of the regulatory framework that governs registered investment companies such as mutual funds and closed-end funds.[8] These regulations include, among other things, provisions governing the approval and renewal of external investment advisory agreements, disclosure of potential return of capital in distributions, and limits on investments from and into other investment companies. However, BDCs have substantial increased flexibility with respect to, among other things, transacting with affiliated entities, incurring leverage (as discussed above), and issuing shares at prices below current net asset value (NAV).

BDCs are generally exempt from the reporting requirements of the 1940 Act, including Form N-CSR, Form N-CEN, and Form N-PORT. Instead, BDCs are subject to the more onerous 1934 Act periodic reporting requirements in the same manner as operating companies. Thus, BDCs must file 8-Ks, 10-Qs, and 10-Ks.

Affiliated Transaction Restrictions

Like registered investment companies, BDCs are subject to restrictions on their ability to transact with certain affiliated persons in order to prevent the type of self-dealing transaction the 1940 Act was originally enacted to prevent. However, BDCs were envisioned as vehicles that would engage in private equity or venture capital style transactions, including transactions with controlled portfolio companies, and Congress accordingly implemented more flexible affiliated transactions rules for BDCs set forth in Section 57 of the 1940 Act.

In the similar manner to Section 17, Section 57(a) of the 1940 Act prohibits certain persons who are closely related to a BDC (close affiliates) from acting as principal, selling securities or property to a BDC or any company controlled by a BDC, buying securities or property from a BDC or any company controlled by a BDC, or borrowing money from a BDC or any company controlled by a BDC. Section 57(a) of the 1940 Act and Rule 17d-1 (made applicable to BDCs through Section 57(i)) also generally prohibit any "joint enterprise or other joint arrangement or profit-sharing plan" between a BDC or any company controlled by a BDC and a close affiliate.

The entities that qualify as close affiliates are set forth in Section 57(b) of the 1940 Act and include, "(i) Any director, officer, employee, or member of an advisory board of a business development company or any person (other than the business development company itself) who is, [through controlling, being controlled by or under common control with], an affiliated person of any such person specified in this paragraph; and (ii) Any investment adviser or promoter of, general partner in, principal underwriter for, or person directly or indirectly either controlling, controlled by, or under common control with, a business development company (except the business development company itself and any person

who, if it were not directly or indirectly controlled by the business development company, would not be directly or indirectly under the control of a person who controls the business development company), or any person who [through controlling, being controlled by or under common control with or through being an officer or director of], is an affiliated person of any such person."

Rule 57b-1provides BDCs with additional freedom to transact with a controlled portfolio company of a BDC than a registered fund enjoys, generally exempting such companies from the affiliated transaction restrictions of Section 57. Further, transactions with "Remote Affiliates" described in Section 57(e)[9] may be effected with approval of a "required majority"[10] of a BDC's board of directors instead of being squarely prohibited.

Further, as noted above, despite being exempt from Section 17 of the 1940 Act, pursuant to Section 57(i), BDCs may generally rely on the exemptive rules that the Securities and Exchange Commission (SEC) has promulgated under Section 17, including, for instance, Rule 17a-7, which permits certain cross trades of certain securities between affiliated funds.

Co-Investment Transactions

As discussed above, Section 57 and Rule 17d-1 generally prohibit joint enterprises or arrangements between a BDC and its close affiliates. The scope of these terms is viewed very broadly by the SEC Staff and encompasses, among other things, investing alongside affiliated entities. Through a series of no-action letters[11], the SEC Staff has generally exempted, subject to the conditions of those letters, joint investments in private securities where the only term that is negotiated is price. However, for direct lending transactions in which numerous critical terms other than price are negotiated by a BDC's investment adviser or its affiliates, additional relief is needed.

Fortunately, the SEC has generally been willing to allow a BDC to engage in private negotiated transactions alongside affiliated entities, subject to a number of conditions,[12] pursuant to one of several standard forms of exemptive relief. However, there is no general relief available at this time, and each sponsor that will be originating loans must seek its own exemptive order.

Nearly all large private credit managers that operate BDCs have sought and received this co-investment exemptive relief. The ability to participate in co-investment transactions plays a critical role in enabling BDCs to rapidly build high-yielding diversified portfolios by allowing the BDC to participate in the proprietary loans directly originated by the sponsor's broader credit platform without itself having enough assets to otherwise engage in such transactions.

Issuing Shares at Prices below Current NAV

Like closed-end funds, in order to prevent the dilution of existing shareholders BDCs are generally prohibited from issuing their shares at a price, net of commissions, that is less than their current NAV.[13] However, unlike closed-end funds, BDCs have two important additional exemptions to this prohibition.[14] First, pursuant to Section 63(2) of the 1940 Act, subject to board and shareholder approval, a BDC may issue its shares at a net price below NAV. Additionally, pursuant to Section 63(2)(A), BDCs may issue its shares at a net price below NAV with only board approval in connection with its initial public offering (IPO).

1934 Act Reporting Obligations

BDCs are required to be registered under the 1934 Act, either pursuant to Section 12(g), for unlisted BDCs, or 12(b) for listed BDCs, and, unlike registered investment companies, are subject to 1934 Act reporting requirements. These include a requirement to file periodic 10-Q and 10K reports and current reports on Form 8K. These reporting requirements will attach to a BDC regardless of whether it is publicly or privately offered. For the purposes of 1934 Act reporting, however, private

BDCs are generally regarded as "non-accelerated filers," as they have no "public float."[15]

BDCs are eligible to rely on the "Emerging Growth Company" special status under the 1934 Act.[16] This enables a BDC to make confidential registration statement filings and, for so long as it remains an Emerging Growth Company, provides an exemption from the costly audit of its controls and procedures required by Section 404(b) of the Sarbanes Oxley Act of 2002 (SOX). BDCs are otherwise subject to the provisions of SOX and, among other things, must comply with the Section 404(a) management report on internal controls requirements following their first year of operations.

Fee Structure

BDCs, as direct lending vehicles that seek to generate high levels of current income, are generally able to charge higher management fees than mutual funds. BDCs typically charge both an asset-based management fee, a performance fee on income, and a performance fee on capital gains.

BDCs' asset-based management fees are typically much higher than those of mutual funds. In addition to charging higher absolute fee rates, BDCs frequently charge their management fees on gross assets, which further increases their attractiveness to the sponsor.[17] However, to mitigate the impact of the new increased leverage limits on shareholders operating under this type of fee structure, a large number of BDCs that have increased their leverage limits to 2:1 have concurrently reduced the management fee that they charge on those assets attributable to the additional leverage.

BDCs are permitted by statute to charge a performance fee on both income and capital gains without being restricted to being offered to qualified clients, and most BDCs choose to charge both. The capital gains performance fee charged by BDCs is a flat percentage of *realized* capital gains less realized and unrealized losses (up to 20 percent). The income-based performance fee is typically structured such that the BDC must, on a quarter-by-quarter basis, clear a hurdle rate, after which it will "catch up" until it receives a set portion of investment income generated by the BDC (up to 20 percent) and thereafter receives that portion of any additional income.

There has been a growing trend in the industry among publicly listed BDCs to attempt to better align the mechanics of their performance fees, particularly the performance fee charged on income, with the overall investment outcomes of their shareholders. Accordingly, a number of BDCs have enacted one or both of (1) total return incentive fee caps and (2) look-back provisions with respect to the incentive fees on income. The total return incentive fee cap functions by effectively reducing the performance fee on income that a BDC can receive by the amount of capital losses that have been incurred within a specified period. The three-year look-back provision requires that a BDC exceed its applicable hurdle rate across a rolling three-year period in order to receive the performance fee, rather than on a quarter-by-quarter basis. A number of private BDCs have opted to enact this provision in connection with a listing in order to help increase the attractiveness of their offerings to underwriters and investors.

The Rise of Private BDCs

Background

Private BDC structures have recently been used by a number of marquee institutional credit managers, including Golub, Carlyle, Bain Capital, Crescent, and Goldman Sachs. The typical offering strategy for these BDCs is to conduct a private placement offering to US and non-US institutional investors followed by either a listing and IPO offering a few years later to the general public or a liquidation a finite time after the initial private offering closes. Some managers have also left open the possibility of launching a series of private BDCs, with each in turn merging into the first BDC of the series to publicly list.

Key Advantages of Private BDCs

Private BDC vs. Private Credit Fund

There are two key advantages of organizing and offering a private BDC versus a private credit fund. First, a private BDC can become a permanent capital vehicle through its subsequent initial public offering (IPO) and listing a few years down the road. A private credit fund typically has a finite life and proceeds into the liquidation mode as it approaches the end of its finite life. A seed investor in a private BDC that trades at a premium to NAV following its IPO and listing will get an extra benefit of a high stock price. Naturally, if the private BDC trades at a discount to NAV, the opposite would be true.

Second, a private BDC is a cleaner tax structure than a private credit fund in respect of blocking ECI and UBTI. While private credit funds that engage in direct lending use their own blockers, treaties, or a season-and-sell approaches to deal with ECI and UBTI issues, a private BDC is its own blocker, plain and simple.

Private BDC vs. Public BDC

With no trading market for private BDC shares, there are no issues with trading at a discount to NAV, something that has historically been an issue for a number of listed BDCs and closed-end funds. The lack of pressure to manage a discount allows private BDCs to deploy capital at a measured pace and build a stable dividend over time without concern for the impact of such a strategy on the BDC's share price. Additionally, because they have no share price, private BDCs are free to raise or draw down additional capital without having to wait for their share prices to be at or above NAV.

Capital Commitments Strategy

Like other private credit funds, private BDCs receive capital commitments from investors, which are then drawn down through a series of capital calls. This structure helps to minimize cash drag while the BDC identifies appropriate loans to invest in. In contrast, publicly offered BDCs that take in substantially all of their capital at once during an IPO will likely need to make investments into syndicated debt, collateralized loan obligations, and other, lower-yielding investments while their portfolios of originated loans ramp up. Additionally, private BDCs are able to take advantage of the often-attractive financing rates offered on credit facilities secured by outstanding capital commitments.

Finally, while all exchange-listed BDCs are required to hold annual shareholder meetings, there is no exchange requirement or federal securities law provision requiring private BDCs to do so. Accordingly, depending on their corporate form, private BDCs can avoid incurring the expenses associated with annual shareholder meetings until listed on an exchange.

Flexible Offering Strategy

Because they are targeted to institutional investors, private BDCs will typically have a more institutional shareholder mix than publicly offered vehicles. Private BDCs may also be offered through wirehouses or placement agents to ultra-high net worth individuals. However, unlike typical private credit funds,[18] only an accredited investor standard is technically required for incoming investors, and private BDCs have the ability to be more broadly marketed if desired.

Private BDCs also have a potential marketing advantage over listed BDCs in that, through fee waivers or contractual provisions, they are able to offer lower management and performance fee rates prior to the IPO period (typically a management fee of 0.75% of gross assets, and a performance fee on both income and capital gains of 15%). These rates are then set to automatically increase (typically to a management fee of 1.50% of gross assets and a performance fee on both income and capital gains of 17.5-20%) following the IPO without the need for a shareholder vote.

No Liquidity During Private Stage

Unlike exchange-listed BDCs, which provide liquidity in the secondary market, and non-traded BDCs, which typically provide liquidity via periodic tender offers, private BDCs typically do not provide liquidity to their shareholders during the private phase of their offerings.[19] Instead, a liquidity event will be required to occur within a set period, typically either a qualifying IPO or the wind down and liquidation of the BDC.

Formation Transactions

Because of the unique regulatory rules associated with BDCs, it is possible to effect formation transactions with warehousing entities, including affiliated entities, in order to provide a BDC with a sizeable initial portfolio of investments. Specifically, BDCs are not subject to the affiliated transaction restrictions of the 1940 Act until such time as they file a Form N-54A electing BDC status. A Form N-54A may be filed very late in the setup process of a BDC, and, accordingly, it is possible to clear the SEC review process, conduct marketing activities, and still be able to effect a formation transaction with an affiliate of the sponsor of the private BDC.

Initial Public Offering

As discussed above, private BDCs may, and frequently do, choose to conduct a subsequent IPO to provide liquidity to their shareholders through the secondary market. Investors who entered the BDC during the private phase of the offering will nearly always be subject to a post-IPO lockup (typically of at least six months from the date of the IPO), which should generally help to alleviate the type of selling pressure public, non-traded BDCs have experienced upon listing.

Additionally, the larger base asset size and the institutional nature of private BDCs' clients can make the share price more stable than those of BDCs that began as publicly offered entities.

Finally, a number of formerly private BDCs currently trade at a premium to NAV, which provides a potential avenue of additional return for their shareholders.

Conclusion

Because of their unique offering characteristics and tax status, private BDCs are a flexible way for private credit managers with a direct lending strategy to attract a wide variety of US and foreign institutional investors and to maintain the funds raised in a permanent capital vehicle.

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NOTES

1 From LCD, an offering of S&P Global Market Intelligence.

2 Developing the Economy 2018.

3 For these purposes, joint ventures are considered private funds exempt under Section 3(c)(7) of the 1940 Act. Accordingly, sponsors must carefully balance the increased leverage provided by using these vehicles against the non-qualifying asset treatment they receive.

4 Additionally, even were the origination of loans not viewed to be a business, the leverage typically employed in these strategies would itself give rise to UBTI.

5 Generally, a RIC's US-source interest income, other than certain contingent interest and interest from obligations of a corporation or partnership in which the RIC or the non-US stockholder are at least a 10 percent stockholder, reduced by expenses that are allocable to such income.

6 Generally, the excess of the RIC's net short-term capital gain over the RIC's long-term capital loss for the applicable taxable year.

7 For private BDCs these conditions include (1) certain disclosure requirements, (2) obtaining either board or shareholder approval, and (3) conducting a tender offer for at least 25 percent of the BDC's

outstanding shares. Listed BDCs are not required to conduct the tender offer. Accordingly, many private BDCs have waited until after listing to increase their leverage limits.

[8] BDCs are not registered investment companies, nor are they exempt from the definition of an "investment company" pursuant to Section 3 of the 1940 Act. Instead, a closed-end fund electing to be treated as a BDC is generally exempt from the provisions of the 1940 Act other than those of Sections 55-65 pursuant to Section 6(f) of the 1940 Act. BDCs, however, are carved back in to a number of 1940 Act regulatory provisions pursuant to Sections 59-65.

[9] Remote affiliates include, "(1) Any person (A) who is, within the meaning of section 2(a)(3)(A) of the 1940 Act, an affiliated person of a business development company, (B) who is an executive officer or a director of, or general partner in, any such affiliated person, or (C) who directly or indirectly either controls, is controlled by, or is under common control with, such affiliated person. (2) Any person who is an affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter of, principal underwriter for, general partner in, or an affiliated person of any person directly or indirectly either controlling or under common control with a business development company (except the business development company itself and any person who, if it were not directly or indirectly controlled by the business development company, would not be directly or indirectly under the control of a person who controls the business development company)."

[10] "Required majority means, "…both a majority of a business development company's directors…who have no financial interest in such transaction, plan, or arrangement and a majority of such directors or general partners who are not interested persons of such company."

[11] *See,* SMC Capital, Inc., SEC No-Action Letter (pub. avail. Sept. 5, 1995) and Massachusetts Mutual Life Insurance Company, SEC No-Action Letter (pub. avail. June 7, 2000).

[12] These conditions include most critically that the BDC participate on the same terms as the affiliated private funds, and, subject to certain carve outs in newer forms of the exemptive relief, that no affiliated entity have an existing investment in the portfolio company prior to the co-investment transaction.

[13] Section 23(b) is made applicable to BDCs pursuant to Section 63 of the 1940 Act.

[14] BDCs may also issue stock at a net price below NAV upon the exercise of any warrant option or right pursuant to Section 63(3) of the 1940 Act.

[15] Pursuant to Rule 12b-2 under the 1934 Act, an issuer will be a "non-accelerated filer" if it has an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of less than $75 million as of the last business day of the issuer's most recently completed second fiscal quarter. Non-accelerated filers have a longer period to file period reports from the end of the applicable period (45 days after fiscal quarter-end for filing a 10-Q and 90 days from fiscal year end for filing a 10-K as compared to 40 days and 75 days, respectively, for accelerated filers and 40 days and 60 days, respectively, for large accelerated filers, as each such term is defined in Rule 12b-2 under the 1934 Act.

[16] Pursuant to Rule 12b-2 under the 1934 Act, an emerging growth company is an issuer that had total annual gross revenues of less than $1,070,000,000 during its most recently completed fiscal year. A BDC will remain an emerging growth company until the earlier of (1) the last day of the fiscal year of the issuer during which it had total annual gross revenues of $1,070,000,000 or more; (2) The last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act of 1933; (3) The date on which the BDC, during the previous three year period, issued more than $1,000,000,000 in non-convertible debt; or (4) The date on the BDC is deemed to be a large accelerated filer. Typically private BDCs will cease being

emerging growth companies following listing pursuant to item (2) or (4) above, and will remain emerging growth companies during the life of their private offering phase.

[17] Many BDCs will exclude cash, cash equivalents and other comparable investments from the gross assets on which management fees are calculated.

[18] Like most private fund offerings, private credit funds have traditionally been exempt from the definition of investment company under Section 3(c)(7) of the 1940 Act. Section 3(c)(7) funds, however, are only available to "Qualified Purchasers" as such term is defined in Section 2(a)(51) of the 1940 Act, which is a significantly higher standard that very few natural persons can meet.

[19] To the extent they desire to do so, private BDCs are permitted to repurchase their shares pursuant to Rule 13e-4 under the 1934 Act.