MORNINGSTAR®

Business Development Companies Are Revving Up for Growth
BDCs are Increasing Leverage Targets and Adding Lending Capacity

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Contents

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Executive Summary

A majority of publicly traded business development companies, or BDCs, are planning to take advantage of the opportunity to increase leverage presented by the changes to the Investment Company Act of 1940 that became effective in March 2018. We calculate that 81% of publicly traded BDCs have already received board approval to decrease their required asset coverage ratio to 150% from 200%, which effectively would allow them to increase their debt/equity ratios to a maximum of 2.0 times from 1.0 times under the prior regulations. We calculate that these BDCs may issue up to $32 billion of additional debt as a result as they increase their target leverage ratios. This debt would almost certainly be used to fund the purchase of a similar amount of new investments and therefore has the potential to increase the size of the publicly traded BDC industry by over 40%. For credit investors, we view the movement toward increased leverage in the BDC sector as largely negative. However, we note that the negative implications may be partially offset by positive impacts, such as increased investment diversification, higher profitability, or the creation of larger cushions between reported leverage and regulatory limits.

Key Takeaways

- The changes to the Investment Company Act of 1940 that became effective in March 2018 are likely to lead to a meaningful increase in leverage for BDCs.
- In late March, 81% of the 48 BDCs traded on major exchanges had received board approval to increase their allowable leverage by reducing their required asset coverage ratio to 150% from 200%. Some 42% had also received shareholder approval to increase leverage, which allows the allowed increase to become effective the next day.
- Only two BDCs are clearly unaffected. One company (Main Street Capital Corporation) indicated that it does not plan to decrease its asset coverage requirement, while Firsthand Technology Value Fund Inc. does not have any debt.

Background

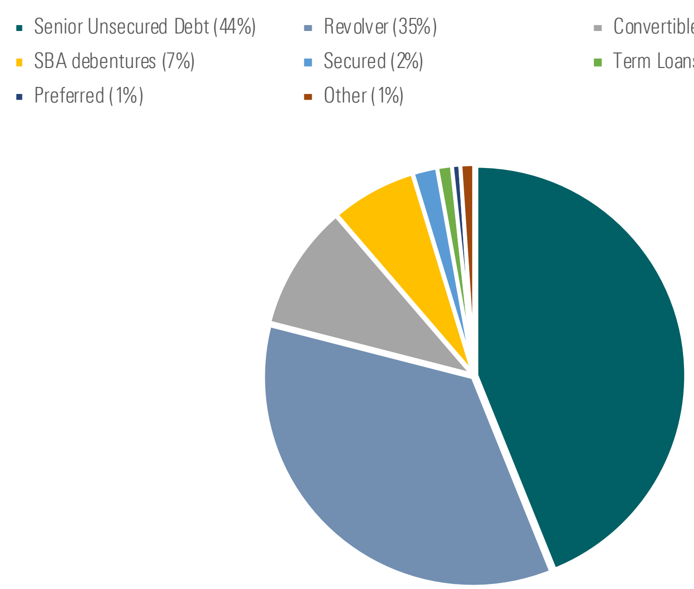
A BDC is a closed-end investment company that invests in small and midsize businesses and is regulated by the Securities and Exchange Commission. The BDC structure was created in 1980 through amendments to the Investment Company Act of 1940. BDCs must invest 70% of investments in eligible assets (generally, unlisted companies or companies with less than $250 million in common equity). BDCs are taxed as registered investment companies and pay little or no corporate income tax as long as they distribute 90% of taxable income to investors as quarterly dividends (like REITs). Most BDCs are publicly traded, and many with total assets over $1 billion have a public credit rating. At the end of 2018, BDCs publicly traded on major exchanged collectively held nearly $70 billion in total assets.

On March 23, 2018, the Consolidated Appropriations Act of 2018 was approved, and it included the Small Business Credit Availability Act that, under certain circumstances, reduces the BDC required asset coverage ratio to 150% from 200%. The asset coverage ratio for BDCs is essentially total assets/equity. More specifically, it is calculated as consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by the senior securities representing indebtedness. If the decrease is approved by a BDC's board, the reduction in requirements will become effective one year later. If more than 50% of voting shareholders at a meeting that meets a quorum subsequently approve the decrease, the decrease is effective the following day.

BDC Debt Funding

Business development company funding consists primarily of senior unsecured debt (an average of 44% of total funding) and bank revolvers (35%), as shown in Exhibit 1.

Exhibit 1 Average Funding Composition of Publicly Traded Business Development Companies



Source: Morningstar Credit Ratings, LLC, Company filings. Data as of Dec. 31, 2018.

A Majority of BDCs Are Electing to Increase Leverage

Of the 48 publicly traded BDCs that we have reviewed, 39 (81%) have received board approval to decrease their asset coverage requirement and 20 (42%) have subsequently received shareholder approval. Of the remaining nine BDCs, one has explicitly stated that it does not plan to decrease its asset coverage requirement and one has no existing debt. An overview of each BDC's progress, including approvals, leverage targets, and estimated effective dates, can be found in Exhibits 5 and 6.

As previously noted, the dates that increases in allowable leverage become effective will vary with the processes that firms follow. An approved decrease in the asset coverage ratio becomes effective one-year board approval or the day after shareholder approval. Over 40% of the planned increases in allowable leverage have become effective by the end of 2018, and we calculate that over 60% are effective at the end of the first quarter of 2019. Some 97% will be effective by the end of 2019, with the last one scheduled to become effective in the first quarter of 2020.

Exhibit 2 A Majority of Allowable Leverage Increases Are Effective as of March 31

ACR Decrease Effective as of:	Number of BDCs	% of Publicaly Traded BDCs	% of BDCs with Approval to Increase Leverage
June 30, 2018	6	13%	16%
September 30, 2018	11	23%	29%
December 31, 2018	16	33%	42%
March 31, 2019	23	48%	61%
June 30, 2019	35	73%	92%
September 30, 2019	36	75%	95%
December 31, 2019	37	77%	97%
March 31, 2020	38	79%	100%
No approved decrease in the ACR	10	21%	--

Source: Morningstar Credit Ratings, LLC, company filings. Data as of March 22.

BDCs have indicated that they plan to increase leverage materially. Prior to the Act of 2018, the median publicly disclosed leverage target for a BDC was 0.7 times – 0.8 times. Now the current median publicly disclosed leverage target has increased to 1.0 times – 1.25 times. Moreover, the range of leverage targets has increased significantly. Prior to the 2018 act, the lowest end of a BDCs target leverage range was 0.5 times (Goldman Sachs BDC Inc. and Monroe Capital Corp.) and the highest end was 1.0 times (Capital Southwest Corp.). Post the 2018 act, the lowest end of the revised BDC leverage target range was 0.6 times (TriplePoint Venture Growth BDC Corp. and KCAP Financial Inc.), while the highest end was 1.75 times (Garrison Capital Inc.).

Exhibit 3 The Largest BDCs Have Made the Most Progress Toward Increasing Leverage

	Count	Received Board Approval	Received Shareholder Approval	Has Leverage Target	Previous Leverage Target (median midpoint)	Current Leverage Target (median midpoint)	Current Average Net Leverage	Current Average Debt/ Equity
All Publically-traded BDCs	48	81%	42%	65%	0.75x	1.15x	0.73x	0.79x
Large BDCs (total assets > $1.0 billion)	18	89%	61%	78%	0.70x	1.23x	0.80x	0.84x
Medium BDCs (total assets $0.5 -$1.0 billion)	11	73%	36%	82%	0.75x	1.11x	0.71x	0.76x
Small BDCs (total assets < $0.5 billion)	19	79%	26%	58%	0.75x	1.08	0.68x	0.76x

Source: Morningstar Credit Ratings, LLC, company filings. Data as of March 22.

BDC Size Appears to Influence Leverage Strategy

Of the 18 publicly traded BDCs with over $1 billion in total assets, 16 (89%) have received board approval to reduce their asset coverage requirement, and 11 (61%) have received shareholder approval. Of the two large BDCs that have not received board approval, one is Main Street Capital Corporation (total assets of $2.5 billion), which has explicitly stated that it does not plan to seek approval to increase leverage. The other is FS KKR Capital Corp. (total assets of $7.4 billion), which was created by the transformational merger of FS Investment Corp. and Corporate Capital Trust in December 2018. FS KKR's management has said it will have a more "detailed dialogue" with investors on leverage now that the merger has been finalized. In contrast, 73% of BDCs with total assets between $0.5 billion and $1.0 billion had received board approval, and 79% of BDCs with less than $500 million of total assets had received approval.

Interestingly, size does not appear to have had an impact on leverage targets prior to the passage of the 2018 act, and median leverage targets were near 0.75 times regardless of size (although the largest firms are slightly lower, at 0.70 times), as shown in Exhibit 3. However, investors may now find a stronger link between size and leverage, with larger firms disclosing higher median leverage targets than smaller firms, and higher actual levels of leverage. For the largest firms, net leverage recently averaged 0.80 times, compared with 0.71 times and 0.68 times, for medium-size and small firms, as calculated by (debt-cash)/(equity).

Potential Debt Issuance

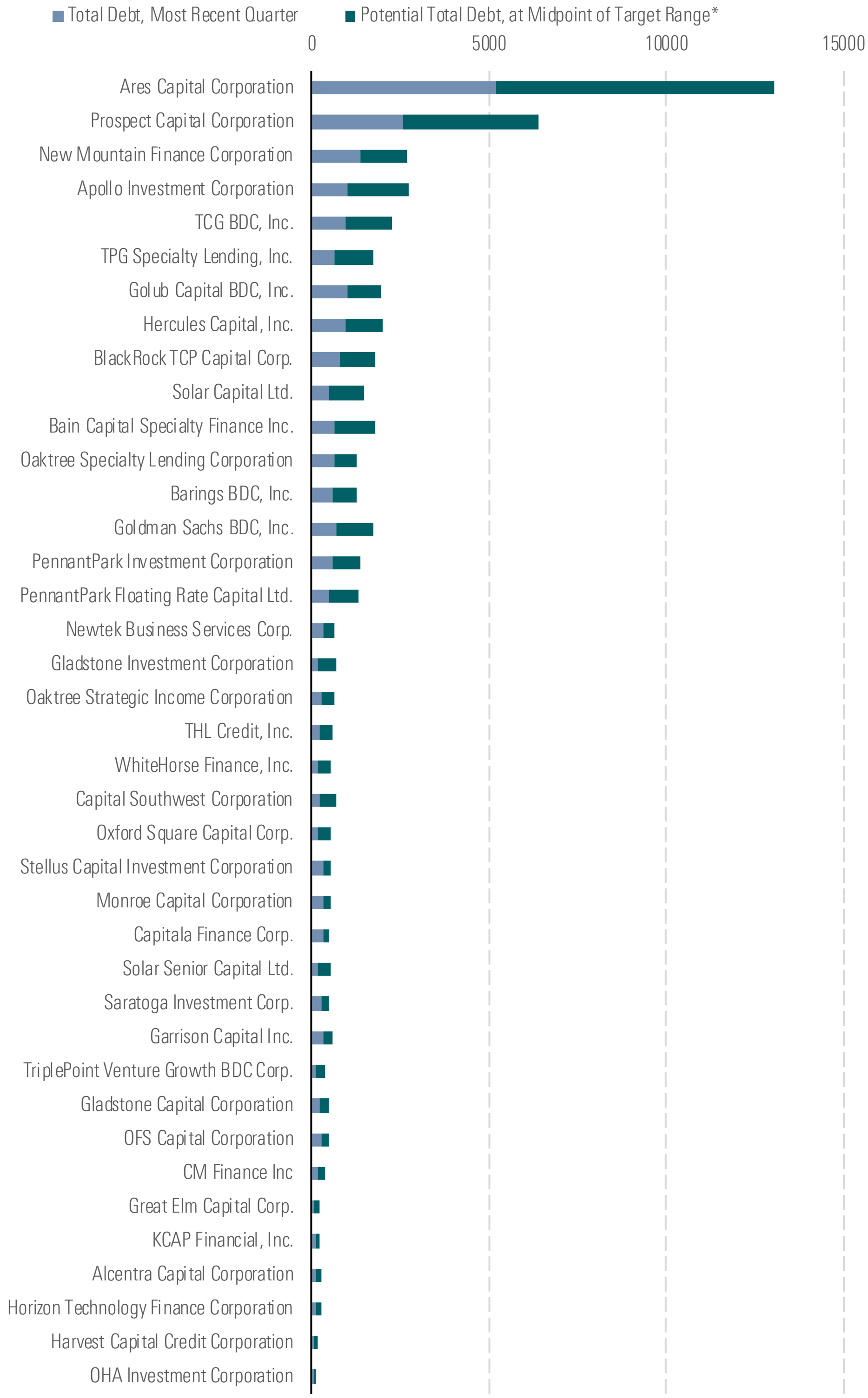
We calculate that BDCs could take on approximately $32 billion of additional debt to fund the purchase of additional investments as a result of the 2018 act.

We assume that:

1. Additional leverage is created by increasing borrowings (as opposed to share buybacks).
2. No new equity is issued.
3. And all firms that have approved a decrease in their asset coverage requirements increase leverage to the midpoint of their target range (or to the average midpoint of the group, if no target range is specified).

The largest firms are likely to issue the bulk of this additional debt, with BDCs with over $1.5 billion in total debt accounting for 69% of potential issuance, as we calculate it. However, midsize BDCs also have the potential to issue meaningful amounts of additional debt. We estimate that BDCs with $500 million–$1.5 billion in total assets could issue $6.3 billion in additional debt, or 20% of the potential total.

Exhibit 4 Business Development Companies May Issue $32 Billion of Additional Debt ($ in Millions)



Source: Morningstar Credit Ratings, LLC, company filings.
*=Assumes a pro forma debt/equity ratio of 1.17 if no target is specified.

Credit Implications

For credit investors, we view the movement toward increased leverage in the BDC industry as largely negative. Increased leverage is likely to make net income more variable over time, which could result in lower scores on the cyclicality metrics within our Business Risk pillar (refer to the Appendix for a summary of how we view business development companies). Increased leverage may also have a negative impact within our Dependence on Capital Markets metrics, especially if untapped revolver capacity does not increase proportionately with other types of debt, or if a company comes closer to breaching its regulatory leverage limits or debt covenant. Higher levels of debt may also have negative implications for a BDC's Cash Flow Cushion score, which compares debt due over the next five years to expected cash flows. The negative implications of higher debt within this pillar are unlikely to offset by higher earnings, given the requirement that BDCs pay out 90% of earnings as quarterly dividends. Within our Solvency Score pillar, higher levels of leverage are likely to have a negative impact on our capital structure and debt-service capability metrics.

However, increased leverage may also have positive implications, which may partially offset downward ratings pressure. If a company uses increased leverage to support increased investments (as opposed to capital returns to shareholders), this could lead to lower investment concentration, which could have a positive impact on our Business Risk pillar. Increased leverage could also lead to higher profitability, which could have a positive impact on our Management Score within our Business Risk pillar, as well as profitability metrics within our Solvency Score. Higher allowable leverage may also allow a firm to operate with a larger cushion between its reported leverage and its regulatory limits and debt covenants, which could also have positive implications for its Business Risk score.

Exhibit 5 Business Development Company Leverage Targets (Alphabetical Order)

Institution Name	Ticker	Total Assets	Debt/ Equity	Board Approval	Shareholder Appoval	Leverage Target (Pre-March)	Leverage Target (Post Approval)	Estimated Effective Date
Alcentra Capital Corporation	ABDC	266,120	0.72	Y	-	0.7x-0.8x	0.6x-0.7x	May-19
Apollo Investment Corporation	AINV	2,383,667	0.76	Y	-	0.60x-0.7x	1.25x-1.40x	Apr-19
Ares Capital Corporation	ARCC	12,255,000	0.71	Y	-	0.65x- 0.75x	0.9x-1.25x	Jun-19
Bain Capital Specialty Finance Inc.	BCSF	1,564,846	0.63	Y	Y	-	1x-1.5x	Feb-19
Barings BDC, Inc.	BBDC	1,377,434	1.01	Y	Y	-	1.25x	Jul-18
BlackRock Capital Investment Corporation	BKCC	799,473	0.43	-	-	0.65x or higher	-	-
BlackRock TCP Capital Corp.	TCPC	1,685,209	0.97	Y	Y	-	-	Feb-19
Capital Southwest Corporation	CSWC	523,781	0.62	Y	-	0.8x-1x	1.5x	Apr-19
Capitala Finance Corp.	CPTA	494,200	1.41	Y	-	0.75x	0.85x	Nov-19
CM Finance Inc	CMFN	301,984	0.86	Y	-	0.75x	1.25x-1.5x	May-19
Fidus Investment Corporation	FDUS	713,498	0.67	-	-	0.7x-0.8x	-	-
Firsthand Technology Value Fund, Inc.	SVVC	246,915	0.00	-	-	No debt	-	-
FS KKR Capital Corp	FSK	7,705,000	0.81	-	-	-	-	-
Garrison Capital Inc.	GARS	442,782	1.35	Y	-	0.9x-0.95x	1.75x	Aug-18
Gladstone Capital Corporation	GLAD	438,424	0.91	Y	-	-	0.9x-1.25x	Apr-19
Gladstone Investment Corporation	GAIN	619,608	0.45	Y	-	0.65x-0.7x	-	Apr-19
Goldman Sachs BDC, Inc.	GSBD	1,343,203	0.93	Y	Y	0.5x-0.75x	1.5x	Jun-18
Golub Capital BDC, Inc.	GBDC	1,979,807	1.03	Y	Y	-	1x	Feb-19
Great Elm Capital Corp.	GECC	288,483	0.60	Y	Y	-	-	May-18
GSV Capital Corp.	GSVC	357,363	0.18	-	-	-	-	-
Harvest Capital Credit Corporation	HCAP	134,988	0.68	Y	-	0.8x	1.25-1.4x	May-19
Hercules Capital, Inc.	HTGC	1,823,054	1.01	Y	Y	0.75x-0.95x	0.95x-1.25x	Dec-18
Horizon Technology Finance Corporation	HRZN	252,162	0.84	Y	Y	0.75x	0.8x-1.2x	Oct-18
KCAP Financial, Inc.	KCAP	279,739	0.64	Y	-	-	0.6x-0.8x	Mar-19
Main Street Capital Corporation	MAIN	2,524,463	0.67	-	-	-	-	-
Medley Capital Corporation	MCC	741,596	1.30	-	-	0.6x-0.7x	-	-
Monroe Capital Corporation	MRCC	499,074	0.86	Y	Y	0.5x	0.7x-0.75x	Jun-18
MVC Capital, Inc.	MVC	347,078	0.49	-	-	-	-	-
New Mountain Finance Corporation	NMFC	2,521,774	1.38	Y	Y	0.7x-0.8x	1.2x-1.4x	Jun-18
Newtek Business Services Corp.	NEWT	622,461	1.03	Y	Y	-	1x-1.2x	Jul-18
Oaktree Specialty Lending Corporation	OCSL	1,551,458	0.70	Y	-	0.6x- 0.8x	0.70x-0.85x	Feb-20
Oaktree Strategic Income Corporation	OCSI	585,132	0.94	Y	Y	0.8x-0.9x	1.2x-1.6x	Jul-18
OFS Capital Corporation	OFS	408,538	1.16	Y	-	-	1.3x-1.4x	May-19
OHA Investment Corporation	OHAI	95,830	1.16	Y	-	-	-	Apr-19
Oxford Square Capital Corp.	OXSQ	522,718	0.47	Y	-	-	-	Apr-19
PennantPark Floating Rate Capital Ltd.	PFLT	1,018,677	0.90	Y	-	0.8x-0.9x	1.4x-1.7x	Apr-19
PennantPark Investment Corporation	PNNT	1,160,119	0.91	Y	Y	0.6x-0.8x	1.1x-1.5x	Feb-19
Prospect Capital Corporation	PSEC	5,969,867	0.77	Y	-	-	-	Mar-19
Rand Capital Corporation	RAND	38,658	0.26	-	-	-	-	-
Saratoga Investment Corp.	SAR	454,045	1.56	Y	-	-	-	Apr-19
Solar Capital Ltd.	SLRC	1,665,292	0.52	Y	Y	0.75x	0.9x-1.25x	Oct-18
Solar Senior Capital Ltd.	SUNS	483,837	0.65	Y	Y	0.8x	1.25x-1.5x	Oct-18
Stellus Capital Investment Corporation	SCM	511,357	1.21	Y	Y	0.7x-0.8x	1x	Jul-18
TCG BDC, Inc.	CGBD	2,147,841	0.90	Y	Y	0.65x-0.75x	1x-1.4x	Jun-18
THL Credit, Inc.	TCRD	558,374	0.67	Y	-	0.6-0.8x	1.05x-1.15x	Mar-20
TPG Specialty Lending, Inc.	TSLX	2,007,041	0.57	Y	Y	0.75x-0.85x	0.90x-1.25x	Oct-18
TriplePoint Venture Growth BDC Corp.	TPVG	438,881	0.22	Y	Y	-	0.6x-1.0x	Jun-18
WhiteHorse Finance, Inc.	WHF	541,843	0.62	Y	Y	0.7x-0.8x	1x-1.25x	Aug-18

Source: Morningstar Credit Ratings, LLC. Data as of March 2019.

Exhibit 6 Business Development Company Leverage Targets (Largest to Smallest by Total Assets)

Institution Name	Ticker	Total Assets	Debt/ Equity	Board Approval	Shareholder Appoval	Leverage Target (Pre-March)	Leverage Target (Post Approval)	Estimated Effective Date
Ares Capital Corporation	ARCC	12,255,000	0.71	Y	-	0.65x- 0.75x	0.9x-1.25x	Jun-19
FS KKR Capital Corp	FSK	7,705,000	0.81	-	-	-	-	-
Prospect Capital Corporation	PSEC	5,969,867	0.77	Y	-	-	-	Mar-19
Main Street Capital Corporation	MAIN	2,524,463	0.67	-	-	-	-	-
New Mountain Finance Corporation	NMFC	2,521,774	1.38	Y	Y	0.7x-0.8x	1.2x-1.4x	Jun-18
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OHA Investment Corporation	OHAI	95,830	1.16	Y	-	-	-	Apr-19
Rand Capital Corporation	RAND	38,658	0.26	-	-	-	-	-

Source: Morningstar Credit Ratings, LLC. Data as of March 2019.

Appendix: Overview of our Analysis of Business Development Companies

Our methodology for rating BDCs incorporates a business-development-company-specific application of the Corporate Credit Rating Methodology. The analysis is based on the same key components, or pillars, as the methodology for nonfinancial corporations: Business Risk, Morningstar® Cash Flow Cushion™, Morningstar Solvency Score™, and Distance to Default. We have adjusted the components of the Business Risk pillars to account for the differences in business model between BDCs and other nonfinancial corporations. Specifically, this analysis places additional emphasis on management and dependence on capital markets, and less on economic moat and size. In addition, this analysis incorporates BDC-specific interpretations of each of the underlying Business Risk components.

The analysis combines qualitative judgments with quantitative financial and market data to arrive at a model-derived credit score. However, the model score is only an input to the final rating decision, which may consider trends in performance, anticipated company actions, macroeconomic developments, or other factors that may not be reflected in the model.

The four key components that drive our analysis are:

1. Business Risk Score: The Business Risk assessment for BDCs is similar to Morningstar's scoring system used for nonfinancial companies. However, we emphasize BDC-specific considerations within each of the underlying rating factors contributing to this score.

    - Size (1-5 points): The size (as represented by total assets) of a BDC is relevant in assessing credit quality, as larger BDCs tend to have greater financial flexibility and may benefit from increased investment diversity and economies of scale. The ranking assigned is relative to the BDC peer set only.

    - Morningstar Economic Moat™/sustainable competitive advantages (1-5 points): The moat measures the sustainability of a company's future economic profits, defined as returns on invested capital over and above the estimate of a company's weighted average cost of capital. Factors like cost advantage, efficient scale, intangibles, network effect, and switching costs are assessed while assigning a moat rating to a company. We believe that a BDC's sustainable competitive advantages, where they exist, are primarily derived from cost advantages and intangible assets. Cost advantages could be built on consistent access to lower-cost funding or a deeply-engrained emphasis on controlling management and operational costs. Intangible assets could be derived from privileged access to an attractive customer base, perhaps because of a long-term relationship with a private equity firm or long-term customer relationships.

- Uncertainty (1-10 points): A measure of our perceived ability to accurately forecast the future cash flows of the company.

- Product/customer concentration (1-5 points): In our assessment of concentration risk in a BDC, we evaluate the level of concentration in the BDC's investment portfolio at the firm, industry, and geographic level. Characteristics of a BDC's largest investments are also closely examined.

- Management Score (1-10 points): The score captures our view of a company's transparency, financial prudence, and managerial resources. This measurement incorporates the depth and breadth of management's experience as well as management's proven performance across a variety of financial metrics. We also consider whether the firm consistently executes on its articulated strategy. The Management Score also considers price/book as a way of incorporating the market's projections for management's performance.

- Dependence on capital markets (1-10 points): This metric evaluates a company's need to access capital markets over our five-year forecast. Because capital markets are unpredictable, a company whose survival depends on near-term access is riskier than a company that could easily continue to operate if all capital markets closed for five years. This metric incorporates equity market access, debt maturities concentration and coverage (untapped revolver capacity and cash vis-à-vis the BDC's long-term debt in our five-year forecast), and the asset coverage ratio.

- Cyclicality of operations (1-5 points): The greater the economic sensitivity of a company, the more likely it will experience financial distress, all else being equal. In assessing a BDC's cyclicality of operations, we evaluate its proven performance during economic downturns, if any, and our view if its likely performance in a potential future downturn.

2. Cash Flow Cushion score: The Cash Flow Cushion evaluates a company's ability to cover debt maturities, interest, and other debtlike obligations. For a full description of the Cash Flow Cushion, please refer to Morningstar's Corporate Credit Rating Methodology in the Methodologies section under the Ratings/Surveillance tab on our website, www.morningstarcreditratings.com.

3. Solvency Score: The Solvency Score includes one ratio from each of these four categories: liquidity (a company's ability to meet short-term cash outflows), profitability (a company's ability to generate profit per unit of input), capital structure (how the company finances its operations), and debt-service capability (how much profit is earned per dollar of interest payments). For a full description of the Solvency Score, please refer to Morningstar's Corporate Credit Rating Methodology in the

Methodologies section under the Ratings/Surveillance tab on our website, www.morningstarcreditratings.com.

4. Distance to Default: The Distance to Default metric is a market-based measure of financial health. We calculate both inputs, equity volatility and the ratio of enterprise value/market capitalization, using daily updated market data. This allows us to incorporate new information faster through the distance to default calculation compared with accounting-based measures of financial health. As a result, our credit ratings can be more responsive to early signs of financial distress.

Morningstar® Credit Research

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