Challenges and opportunities in the highly competitive BDC space

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After peaking at the end of the first quarter of 2017, Business Development Companies (BDCs) encountered a bit of turbulence through the end of the year, with many BDCs experiencing earnings pressure as a result of a dip in loan pricing, increased repayments by portfolio companies, and an uptick in nonperforming loans.

Toward the end of last summer, *BDC Reporter*, a publication focusing on BDC news, risks and opportunities, mused about whether the BDC bull market was nearing an end. At that time, the Wilshire BDC Index was barely in positive territory. The index clawed back as we headed into autumn, only to fall again in the fourth quarter. For the full year ended December 31, 2017, the index produced a total return of 0.25 percent.

Thus far in 2018, BDCs as a sector have rallied. This is attributable perhaps to tax reform tailwinds and the fact that a number of companies were oversold and, as a result, somewhat undervalued. Through mid-year (June 30, 2018), the Wilshire BDC Index produced a total return of 4.62 percent.

To get a deeper perspective on the BDC market, we spoke with a group of professionals—both from within KPMG, as well as subject-matter experts from outside firms that service the BDC community—who are highly qualified to comment on a broad cross section of topics that are central to the ongoing viability of this evolving space. The following summarizes their insights and a number of themes relevant to the BDC space.

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State of the market

Sean McKee, National Practice Leader—Public Investment Management, KPMG

Looking at the current credit market, BDC managers are focused on reducing volatility and compressing yields, a dynamic largely attributable to the fact that net new issuance has been trending down amid significant demand for higher-yielding products in a mostly benign credit environment. And although capital formation has been strong, deal issuance in the middle market has not quite caught up, leading one to wonder whether the capital base has effectively outgrown the opportunity set. Perhaps of greater concern is the deteriorating nature of credit agreement terms—with an increasing number of deals having EBITDA add-backs. Moreover, the time horizon lenders allow for companies to use those add-backs has increased meaningfully, which only increases the ability of these companies to prolong a potential technical default.

In this very competitive environment, in which deal structures are under immense pressure, BDC managers must work hard to participate in the most attractive deals. What can they do? One option is to take on more risk in an attempt to secure more attractive yields. They could do this by giving up a bit on credit, structure, and leverage in an effort to be accretive to the dividend and maintain their yield. They could also accept lower yields, but that can be very complicated in a yield-driven BDC structure. Another route would be to simply originate less loans, but that isn't an attractive strategy for most BDCs, either. Finally, BDC managers can explore ways to differentiate themselves—better execution, scalability, speed, specialized institutional knowledge, etc. This, in our view, is the most productive strategy.

> “One trend we expect will accelerate is BDC M&A activity. There are a growing number of large, established credit managers that have set up one or more public or private BDCs. We expect these managers to be very acquisitive over the next year or two, especially if the stock prices of some of the smaller listed BDCs trade at a larger discount to NAV.
>
> – Richard Horowitz
> Partner and Cohead of
> Dechert's Permanent Capital Vehicle Group”

Legislative developments

Priya Dayananda, Managing Director, Federal Government Affairs, KPMG

Legislatively, the shifting budget/debt ceiling and the recently enacted tax law garnered much attention on Capitol Hill over the past 18 months and will continue to do so for the foreseeable future. The overall regulatory relief bill, known as the CHOICE Act, which rolls back significant portions of Dodd-Frank, passed in the House in May 2017 on a party line vote, although the Senate did not pass a new financial services regulation. The Small Business Credit Availability Act, sponsored by then-Representative Mulvaney—which contained a number of changes BDCs have been pushing for—was not reintroduced as a stand-alone bill, but was included as a provision of the CHOICE Act, which in October was broken up into 21 individual bills by the House Financial Services Committee.

The CHOICE Act features a variety of regulatory changes that could impact BDCs, but two stand out in particular. One would afford BDCs greater flexibility in meeting the 70 percent qualified assets requirement, which would enable some currently nonqualified financial services companies to be considered qualified assets. The other would allow BDCs to offer different securities to sophisticated qualified institutional investors. These are in addition to provisions for shorter registration statements and prospectuses, which would position BDCs to raise capital more efficiently, and respond to market conditions more quickly. Another proposal, automatic shelf registrations, would enable BDCs to take advantage of frequently changing market windows.

Congress passed, and the president signed, a $1.3 trillion omnibus spending bill on March 23, 2018. The measure essentially funds every discretionary area of the federal government through the end of the fiscal year on September 30. Of note for BDCs, the legislation included the Small Business Credit Availability Act—originally introduced on January 18, 2018 by Senators Heller and Manchin—which loosens current leverage restrictions on BDCs by reducing the required asset coverage from 200 percent to 150 percent (subject to certain initial approval and ongoing reporting requirements). It also streamlines offering, filing and registration under the Securities Act of 1933.

> “The recent enactment of the Small Business Credit Availability Act is a net positive for Business Development Companies. For example, enabling BDCs to increase their debt to equity ratio from 1:1 to 2:1 will give them greater opportunities to invest in more small and mid-sized businesses so they can grow and create more jobs. We look forward to working with the BDC community to ensure that policymakers continue to improve the regulatory environment for BDCs.
>
> – Jason Mulvihill
> General Counsel
> American Investment Council”

The tax picture

Deanna Flores, Principal, National Tax Leader— Public Investment Management, KPMG
Deirdre Fortune, Partner, Deputy Tax Leader— Public Investment Management, KPMG

Generally, BDCs elect to be taxed as RICs (regulated investment companies). As a result of this election, certain obligations are required to be met including the "90 percent distribution" requirement. During the financial crisis, the ability to meet the distribution requirement became a challenge. From 2008 to 2010, REITs and subsequently RICs were granted the ability by the IRS to distribute their own stock and have it treated as property that is a distribution and eligible for a dividends-paid deduction provided certain conditions were met. However, since 2010 REITs and RICs have been required to go to the IRS and submit a private-letter ruling in order to be able to take a dividends-paid deduction for their stock distributed in this manner. This has been a time-consuming, expensive, and an administratively burdensome process.

In August 2017, the IRS issued Revenue Procedure 2017-45, which allows publicly offered RICs, including publicly offered BDCs, to distribute their own stock and have it treated as property that is a distribution and eligible for the dividends-paid deduction. The provision does have specific requirements: The BDC must distribute its own stock to its shareholders; shareholders must have the ability to elect to receive the distribution in either cash or stock; and at least 20 percent of the distribution must come out of cash. Unlike similar guidance provided by the IRS during the financial crisis, Revenue Procedure 2017-45 is open-ended and applies to distributions on or after August 11, 2017.

Another item people in the BDC space have been focused on is tax reform. The massive legislation, with $5.5 trillion in tax cuts and more than $4 trillion in new tax increases over the next 10 years, includes substantial changes to the taxation of individuals, businesses in all industries, multinational enterprises, and others. While the new law revised the personal tax brackets, with the highest bracket decreasing to 37 percent (from 39.6 percent), there was no change in the 20 percent rate applicable to long-term capital gains and qualified dividend income and no change in the 3.8 percent tax on net investment income.

Significant changes to the tax treatment of derivatives, including those introduced as part of the Modernization of Derivatives Act (MODA), also were not included as part of the new tax law. We do expect Congress to take up the tax treatment of derivatives in the future, although it is hard to predict when this might occur.

However, BDCs will be impacted by certain changes in the new tax law, including the requirement to recognize certain income no later than the tax year in which such income is taken into account for financial statement purposes. Fees impacted by this new requirement would include upfront loan origination fees that are included in income by a BDC currently for financial statement purposes, but are accrued into income for tax purposes over the life of the debt instrument as original issue discount.

In addition, "qualified REIT dividends" and "qualified publicly traded partnership income" are eligible for a 20 percent deduction under the new tax rules for business income of individuals from partnerships, S Corporations or sole proprietorships. While an amendment was introduced as part of tax reform to extend comparable treatment to BDC dividends, it was not enacted. The Investment Company Institute (ICI) is seeking regulatory relief from the Treasury Department to address the disparate treatment of dividends paid by RICs that invest in REITs or MLPs. The ICI is not, however, seeking relief for BDC dividends under the new tax law.

While the new law imposed limitations on the ability of corporate taxpayers, including BDCs and other RICs, to deduct net business interest expense, this is not expected to have a significant impact on BDCs, which also derive significant amounts of interest income. Finally, BDCs should consider the impact of the reduction in the corporate tax rate to 21 percent (from 35 percent) and changes to the taxation of pass-through entities on their structuring opportunities and alternatives.

Corporate governance

Cynthia Krus, Executive Partner, Eversheds Sutherland (US) and a member of the Global Executive Management Team and the Global Board of Eversheds Sutherland

The compliance element of a BDC board of directors is much more significant than almost any other type of corporate board because BDCs are regulated by the '40 Act, the '33 Act, and the '34 Act, as well as the stock exchanges in the case of publicly traded BDCs. One of the key things with which BDC management must grapple is to try to provide the board with as much timely, pertinent, and meaningful information as possible, and ensure the board knows what to do with it. The SEC looks at boards of directors as gatekeepers. They really want the board to be their eyes and ears, watching over management to make sure they're doing everything they need to do.

Today's BDC boards and principals must contend with a broad array of governance issues, including annual and quarterly reporting; co-investment relationships; valuation—including the use of third-party valuation firms; the growing importance of independent counsel; expense allocation requirements; whistleblower protection; cybersecurity; and board composition.

One of the most dramatic changes in recent years has been the sheer volume of information that boards need in order to approve the advisory contract under Section 15(c) of the 1940 Act.

Regulatory matters

Matt Giordano, Deputy Lead Partner— Public Investment Management, Department of Professional Practice, KPMG

There have been a number of high-level changes at the SEC over the past year including both at the chairman and division director levels which will have direct ramifications for BDCs. Chairman Jay Clayton was sworn in on May 14, 2017 and, as expected, has been focused on retail investors and capital formation. The Division of Investment Management also has a new director, Dalia Blass, who has vast public and private experience and is well versed in BDC regulatory matters.

With respect to the Office of Compliance Inspections and Examinations (OCIE), we have seen a significant increase in the number of OCIE exams over RIA, including RIAs to BDCs, over the past two years. Many folks thought under the new administration there could be a decrease in the number of exams, but over the past couple of years we have seen the percentage of RIAs examined jump from approximately 11 percent to over 15 percent. Based on public comments made by SEC staff, we believe the increase in OCIE exams will be a continuing trend in 2018. OCIE recently released its 2017 priorities, and although BDCs are not a thematic focus area, there are a number of areas that do pertain to BDCs, including items such as cybersecurity, AML policies and procedures, and the fact that there are significant retail investments in BDCs.

OCIE issued a risk alert which highlights five of the most frequently cited topics in deficiency letters: 1) Compliance rule; 2) Regulatory filings; 3) Custody rule; 4) Code of ethics rule; and 5) Books and records rule.

The Division of Enforcements released its 2017 results earlier this year, which showed a decrease in the number of enforcement actions as well as total money ordered. The division also laid out its focus areas going forward, which include a number of items impacting retail investors and a focus on individual accountability.

Finally, BDCs should pay attention to recent financial statement comments from SEC staff. One area, in particular, is changes to the new Regulation S-X disclosures, which were part of the SEC's Investment Company Reporting Modernization rulemaking.

> "With the SEC's focus on capital formation and retail investors, we will continue to see changes in the regulatory landscape for BDCs. Although there has been a slight decrease in enforcement actions in 2017, there has been a significant increase in the number of OCIE exams. I would encourage BDCs to take a fresh look at policies and procedures as we believe there will be a renewed focus from exam staff in this area.
>
> – Matt Giordano"

Accounting update

John Russo, Partner, Audit, KPMG
Tim Jinks, Partner, Audit, KPMG

The SEC came out with new rules in 2016 that are relevant for BDCs. The new rules, which became effective in the third quarter of 2017, cover investment company reporting modernization, including amendments to Regulation S-X and disclosure requirements for BDCs and investment companies. BDCs should also be aware of the related guidance around investment company reporting modernization issued by the SEC staff.

BDCs also need to take note of the recent discussion of the FASB's definition of a public business entity and the potential ramifications for disclosure requirements and financial statements. Another hot topic right now in terms of aligning traditional accounting with the BDC structure is offering costs in the context of continuous offerings or expense limitation agreements. BDCs should develop accounting policies that match the offering costs with the proceeds of the offering raised as closely as possible.

A PCAOB change worth highlighting in connection with BDCs is a new standard for the auditor's report, which includes the communication of critical audit matters. The intention is to take the most challenging, subjective, and complex auditor judgments and put them right in the report.

Looking ahead

Despite ongoing volatility we believe BDCs remain a sustainable go-to source for small- and middle-market financing. This is a position the overall credit market recognizes and appears to value. Against that backdrop, although there will be periodic market, regulatory, accounting, and legislative disruptions, in a growing economy BDCs as a sector can be a viable element of a strategically diversified portfolio.

How KPMG can help

In the United States, KPMG has over 7,800 dedicated financial services partners and professionals. KPMG's Financial Services practice serves the market by industry-specific sectors, including Asset Management, Banking and Capital Markets and Insurance. This approach enables us to align more closely with our clients' businesses, strengthen our professionals' industry knowledge, and enhance the quality of service and insights we deliver.

Within Financial Services, KPMG's Asset Management practice is one of the firm's fastest-growing sectors. We have dedicated considerable resources to becoming a leading service provider to BDCs and specialty lenders. A combination of deep industry knowledge and experience, and a cultural commitment to providing outstanding client service makes KPMG the right team to serve your business.

Perhaps the greatest indicator of our depth of experience as a professional services provider to BDCs is the caliber of the clients we serve. KPMG provides professional services to 67 percent of BDCs with at least $1 billion in net assets and 47 percent of those with at least $500 million in net assets. Similarly, we provide audit services to 33 percent of BDCs with at least $1 billion in net assets and 23 percent of BDCs with at least $500 million in net assets.

To learn more visit us at KPMG.com.

Contact us

Reach out for more on our current and future outlook for the BDC market—both operationally and from an investment perspective.

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