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BDCS' LEVERAGE RESTRICTIONS RELAXED IN NEWLY PASSED BILL

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The Small Business Credit Availability Act (SBCAA), which is part of the $1.3 trillion spending bill signed into law on March 23, allows Business Development Companies (BDCs) to take on more leverage, enabling them to invest in more middle-market U.S. businesses.

BDCs were created by Congress in 1980 to increase the availability of capital for growing businesses that may not have access to traditional sources of capital. BDCs—many of which are publicly traded—operate similarly to private equity firms in that they invest in private companies in the form of debt or equity securities. They are also prominent lenders to U.S. middle-market companies, including those backed by private equity.

Under the SBCAA, regulatory asset coverage requirements for BDCs will decline to 150 percent of debt from 200 percent of debt, allowing BDCs to increase debt-to-equity leverage to 2.0x from 1.0x. Still, BDCs would need to receive approval from either their shareholders or a majority of independent directors of their board before increasing leverage. They would also need to have their banks amend their asset coverage covenant to allow for increased leverage levels.

Some BDCs have been requesting this change for years, arguing that it would increase the availability of debt to the middle market while improving returns for their investors. Bills introduced in 2012 (H.R. 5929), 2013 (H.R. 31 and H.R. 1800) and 2015 (H.R. 3868) attempted, but ultimately failed, to get that change through.

In an October 2013 letter, then Securities and Exchange Commission chair Mary Jo White discussed her views regarding an increase in leverage for BDCs. "Reducing the required asset coverage to 150 percent would permit the same BDC to [double] its leverage. A BDC's assets would have to lose only 33 1/3 percent of their value before exposing shareholders to a total loss of their investment."

However, credit ratings agency Fitch Ratings noted in a March 26, 2018 press release that "the potential for negative ratings pressure for BDCs from increased leverage depends upon how individual managers utilize the relaxed leverage guidelines relative to their

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portfolio risk profile." Fitch also said that passage of the recent bill will not result in immediate sector-wide rating changes.

It remains to be seen how much more leverage BDCs will take on. After all, even under the restriction of keeping debt-to-equity at 1.0x, average leverage for rated BDCs was only 0.65x as of Dec. 31, 2017, according to Fitch. Moreover, the agency noted a modest improvement in BDC leverage in 2017, as several firms de-levered, using a portion of portfolio repayment proceeds during the year to pay down debt.

Some BDCs are already taking steps to allow for leverage increases. Since the changes were announced, FS Investment Corp., Gladstone Capital Corp., PennantPark Floating Rate Capital Ltd. and Apollo Investment Corp. have received board approval to modify their asset coverage requirements.

Ares Capital Corp. is likely going to follow suit, having said in early April that the new provision "will enable BDCs to provide more capital to middle market companies while improving portfolio diversification and capital markets access for the BDC industry. The passage of this legislation provides BDCs a choice to operate with greater flexibility and meaningfully enhances the growth prospects for our industry."

The Investment Program Association (IPA), which supports individual investors' access to a variety of portfolio diversifying investment products, released a statement after the spending bill was passed. IPA noted that "small and mid-size businesses [will] … have access to additional growth capital resulting in meaningful domestic investments and job creation" and that "individual investors will have more investment choices." Further, the SBCAA brings BDCs in line with the same rules already established by Congress and regulators for other public reporting companies.

The SBCAA also requires the SEC to streamline the offering, filing, and registration process for BDCs. For instance, it instructs the SEC to, within one year of enactment, include instructions that allow for incorporation by reference. BDCs will be able to file automatic shelf registration statements to expedite their securities offering process, rely on the "free writing prospectus" rules which will facilitate market communications, and save time and costs related to prospectus delivery in connection with registered offerings.

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