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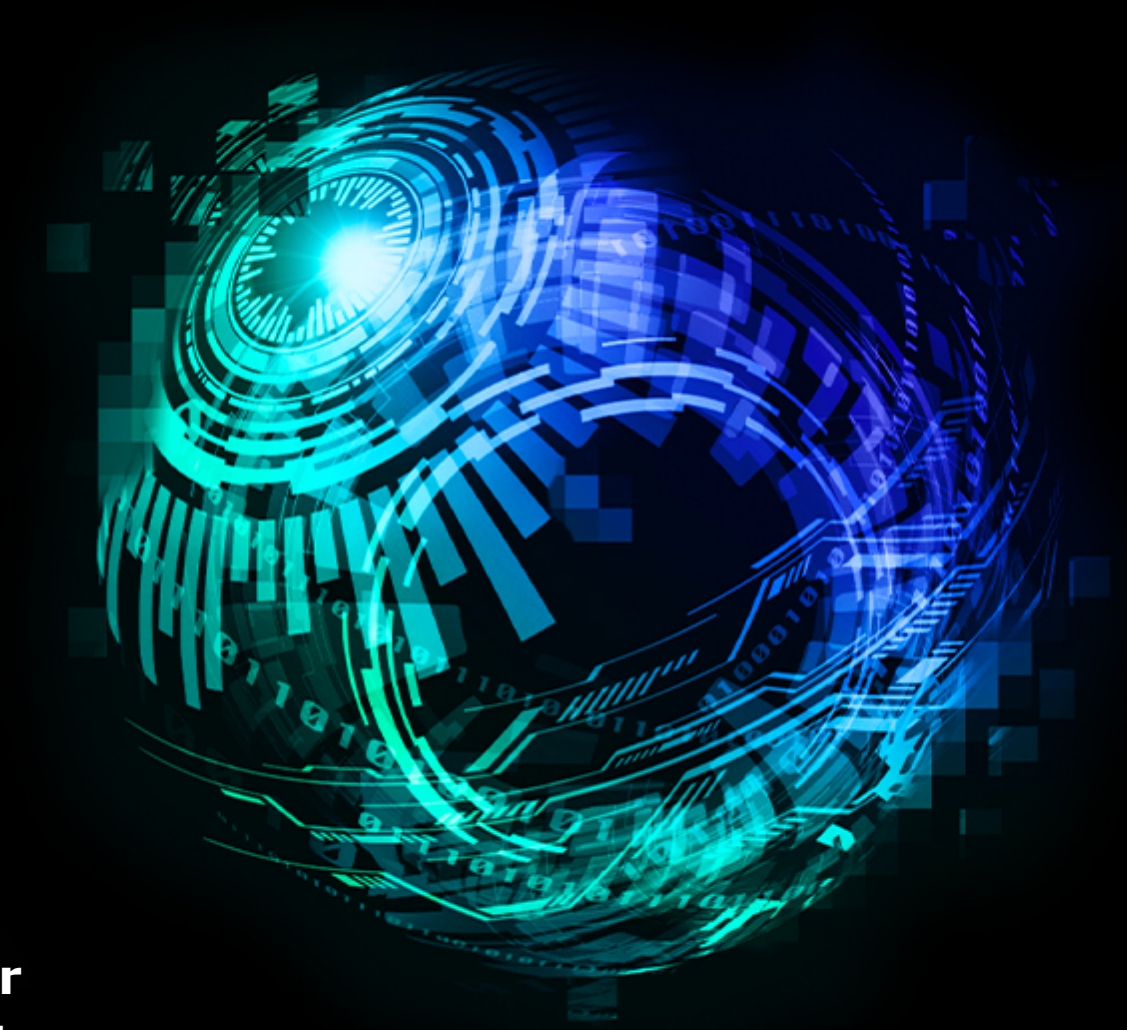


A look at the future for business development companies

June 2019

Alternative investment advisers continue to provide value through business development companies (BDCs)

Accredited and institutional investors have used BDCs as an additional diversification vehicle from public equity and debt markets since their creation in 1980

Often when banks decide not to provide financing to small and medium-sized businesses, PE firms and others step in by raising capital from investors and forming one of three types of BDCs[1]

Business development company structures

Traded

Raises funds through an IPO and is listed on a national exchange

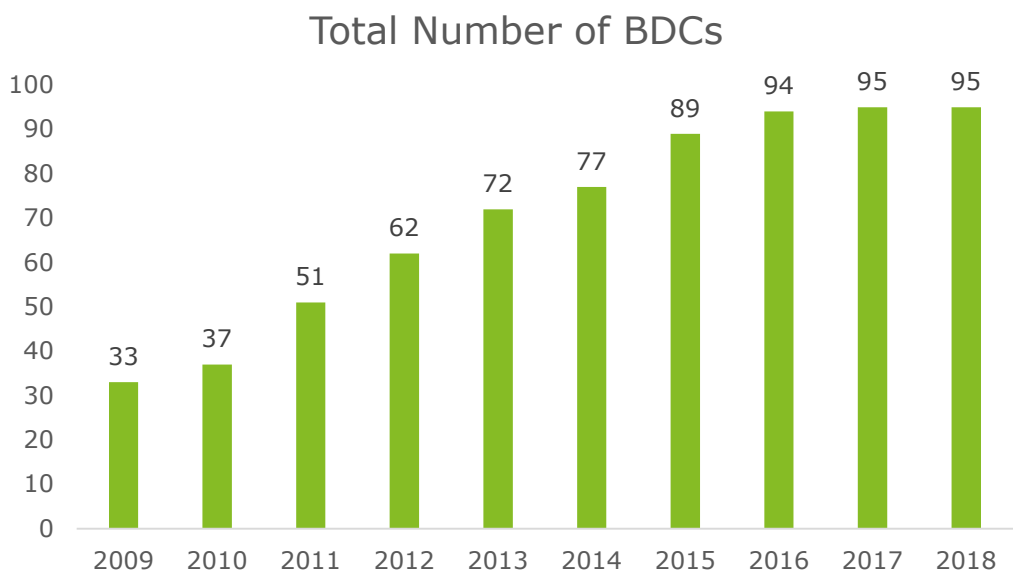
Non-traded

Continuously offers shares up to a maximum amount and typically makes investments as shares are sold

Private

Offers shares in a private offering to accredited investors and generally makes capital calls when investments are found

While the explosive growth in the number of BDCs in the early 2010s has not been replicated as of late, new BDCs have been created even as others have withdrawn the designation[2]



Sources: [1]Tracy Alloway and Arash Massoudi, "Non-bank lending steps out of the shadows," Financial Times, February 25, 2014.
[2]SEC Edgar filings; Deloitte analysis.

Asset growth continues as a favored BDC structure emerges

Raising capital through a private offering has become the preferred method

Growing assets

BDCs continue to experience rising assets, albeit at a slower rate: the 5-year compound annual growth rate (CAGR) of total assets from 2010 to 2014 was 25%, whereas the CAGR from 2014 to 2018 fell to about 5%[1]

Changing assets flows

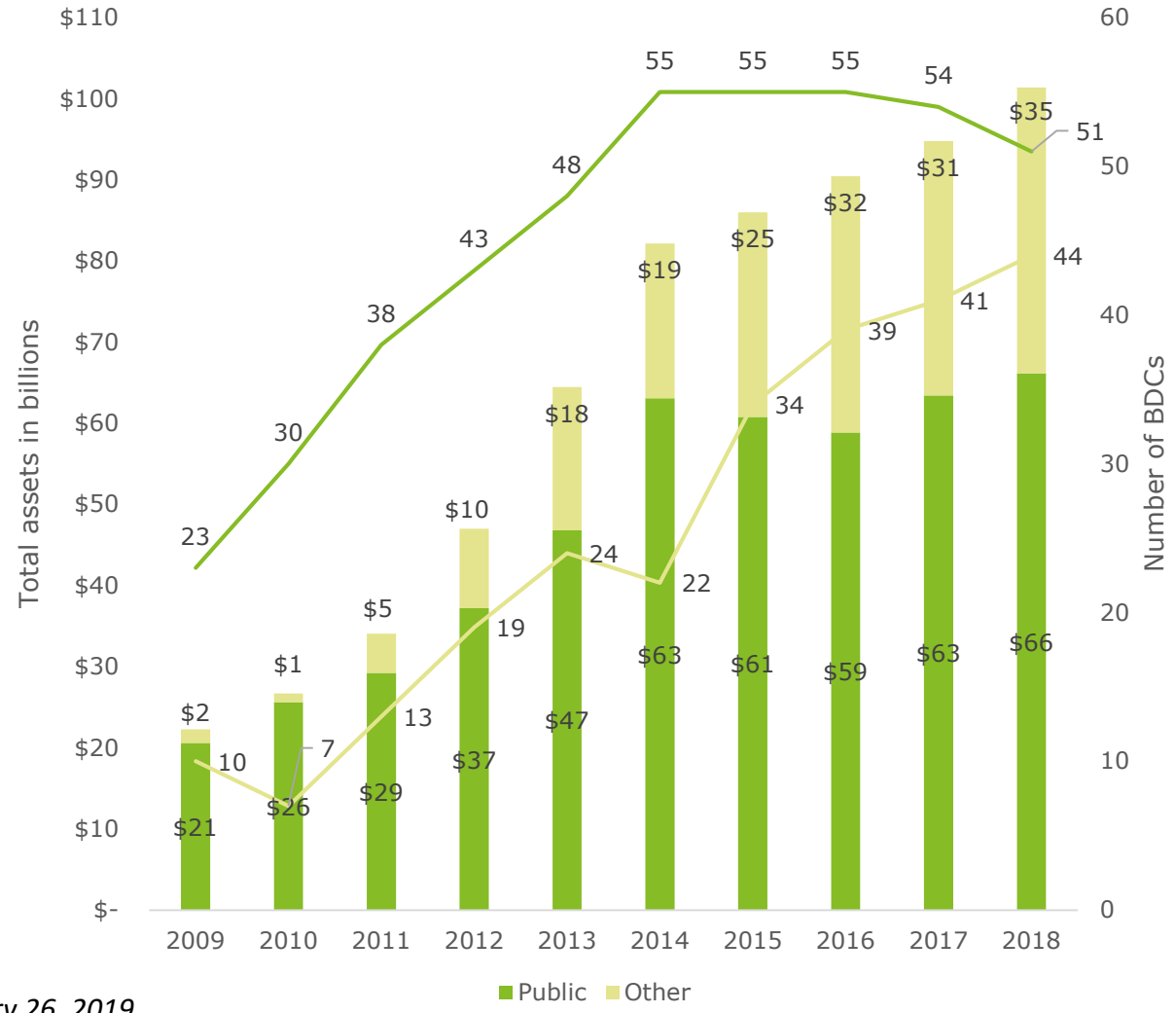
The percentage of total assets held by public BDCs has fallen over the past 10 years, from over 90% in 2009 to 65% in 2018[1]

Public out of favor

The number of publicly traded BDCs has fallen, from 55 in 2014 to 51 at the beginning of 2019 due to mergers and firms opting to operate as private BDCs[1]

Preference for private

Since 2011, more than 25 private BDCs have been launched with the majority still operating today as such, only two have gone public through an IPO[2]



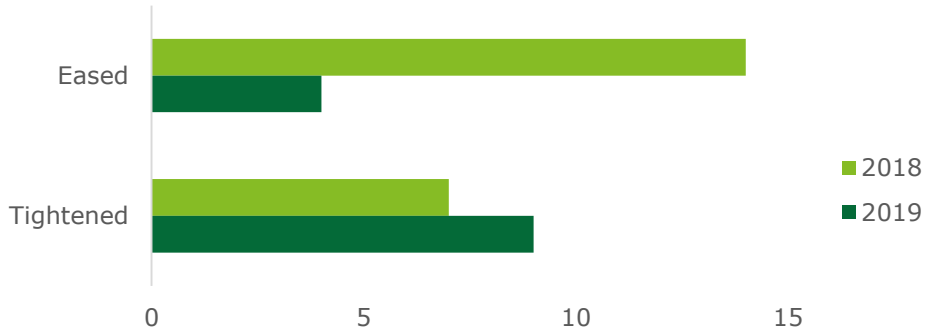
Sources: [1]SEC Edgar filings; Deloitte analysis.
[2]Dechert LLP, "Private Credit, BDCs and Everything in Between: Private BDCs," webinar, January 26, 2019.

Despite the slowdown in asset growth, the future of BDCs looks intriguing

A resurgence of interest may be on the horizon as some banks tightened credit policies

While some banks shift direction on lending standards, BDCs received additional flexibility thanks to recent federal legislation[1]

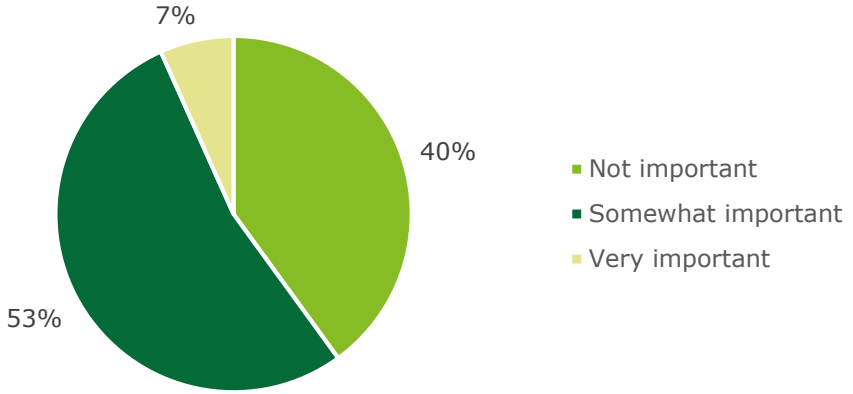
Banks have tilted their lending standards away from easing over the past year[2,3]



Number of banks tightening or easing credit standards over the previous 3 months

Many banks cited a change in risk tolerance as a determining factor in their decision to tighten credit standards during Q4 '18

Reduced tolerance for risk as a reason for tightening credit standards or loan terms[3]



- BDCs can now maintain a debt-to-equity ratio of 2:1, an increase from 1:1[1]
- While higher leverage may increase risk as well as rewards, it is still well below that generally afforded to banks
- BDCs with successful strategies now have greater opportunity to differentiate themselves and attract capital from investors seeking additional risk

Sources: [1]Aaron Back, "These lenders are cheering the spending bill," The Wall Street Journal, March 23, 2018.
[2]Federal Reserve, "Senior Loan Officer Opinion Survey on Bank Lending Practices," January 2018.
[3]Federal Reserve, "Senior Loan Officer Opinion Survey on Bank Lending Practices," January 2019.

Possible changes ahead on the regulatory front

Recent indications suggest the SEC may be seeking to simplify the process for other fund types to invest into public BDCs

On December 19, 2018, the SEC requested comments concerning new rules that would alter several regulations on BDCs[1]:

"This proposal would create a consistent, rules-based framework for fund of funds arrangements while providing robust protections for investors."

- SEC chairman Jay Clayton[1]

AFFE Rule

- Potential changes to the Acquired Fund Fees and Expense Disclosure (AFFE) rule adopted in 2006 which stipulates that the acquiring fund (e.g., an ETF or mutual fund) must combine the fees and expenses of the acquired fund (e.g., a BDC) with their own
- The new SEC proposal is "designed to prevent duplicative and excessive fees in fund of-funds arrangements by requiring an evaluation of aggregate fees."[1]

3-5-10 percent rule

- Proposed removal of the "3-5-10 percent" rule in section 12d-1-A of the 1940 Act that restricts the amounts registered investment companies (mutual funds, unit investment trusts, listed and unlisted closed-end funds, and ETFs and BDCs) can invest in other registered investment companies
- Currently, the rule limits investments to no more than: 3% of another fund's voting securities, 5% of its total assets in any one fund, and 10% of its total assets in funds overall
- The new rule will also permit investments into non-traded BDCs
- While the SEC can provide exemptive relief in certain cases, its proposal aims to "enhance investor protections while providing funds with flexibility to meet their investment objectives in an efficient manner."[1]

These adjustments may expand the options for investments and could generate more interest in both traded and non-traded BDCs

Source: [1]SEC , "SEC Proposes Rule Changes for Fund of Funds Arrangements," December 19, 2018.

Alternative investments advisers offering BDCs should consider any potential strategic implications of the proposal

Final comments have been requested by the SEC concerning the hundreds of questions posted about the proposed amendments[1]

The numerous questions put forth by SEC require varying levels of consideration[1]:

Some may appear rather straightforward

"Are we correct that acquiring funds typically buy and sell ETF shares on the secondary market?"

Others require more analysis to fully grasp any potential effect

"Would including these unlisted closed-end funds and BDCs in the scope of 'acquired funds' affect an acquiring fund's liquidity risk management, including acquiring funds subject to rule 22e-4 under the 1940 Act? If so, how?"

Aside from prioritizing the queries from the SEC, alternative investment advisers should ask themselves several questions:

- What does the proposed change to the AFFE rule mean?
- How could the change in the controls provisions (12d-1-A) affect our funds?
- What actions should be taken now to prepare?

Source: [1]SEC, "Fund of Fund Arrangements," Federal Register, Release Nos. 33-10590, February 1, 2019.

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