Deloitte.

BDCs
Managing through COVID-19

Regulatory relief is keeping business development companies on their feet, but the bout is far from over

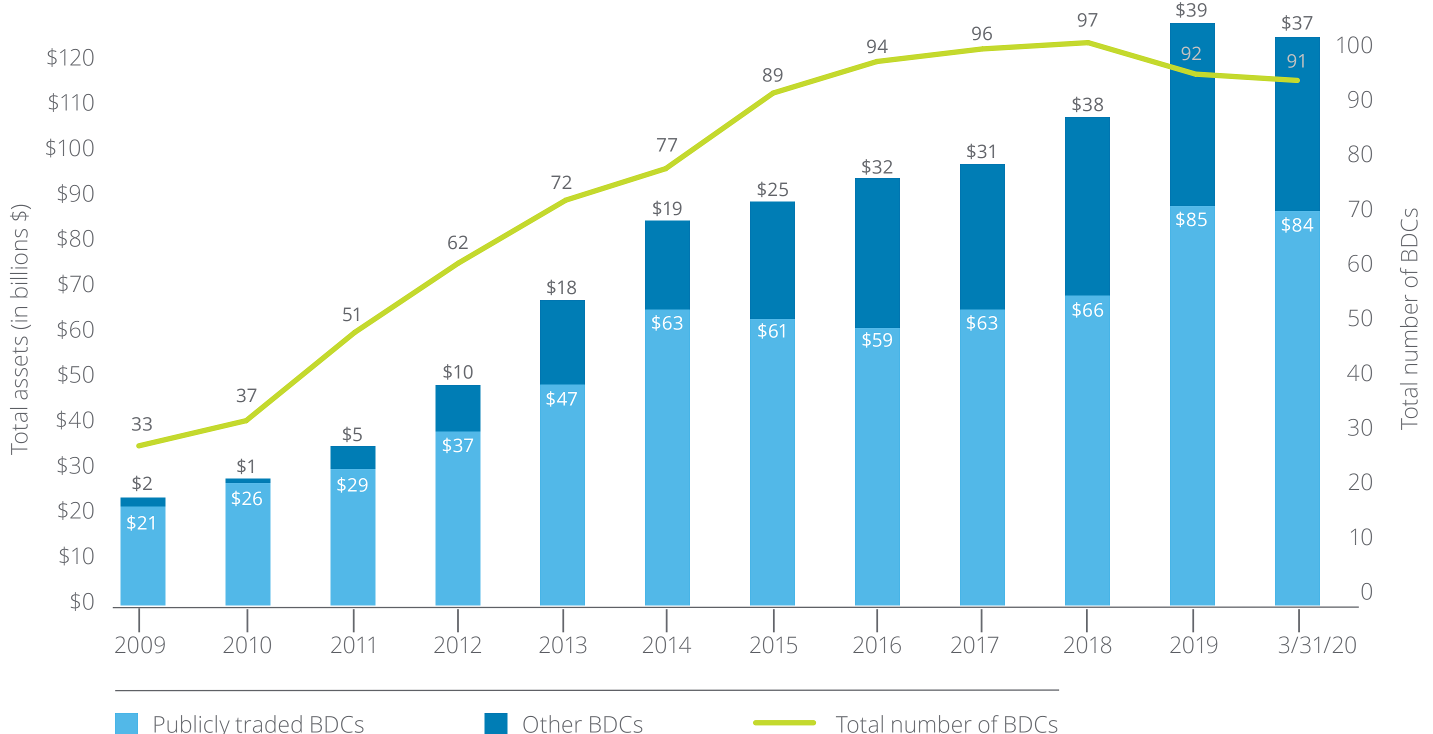
For business development companies (BDCs), the market turmoil driven by COVID-19 has brought some uncertainty to the industry, and BDCs are weathering the storm. Since they mainly provide debt financing to small and medium enterprises (SMEs), a segment hit hard by the virus, publicly traded BDCs faced significant price volatility at the start. Some traded at discounts of up to 50 percent of their net asset value (NAV) in the initial stages of the pandemic.[1] Markets have since stabilized for BDCs, and we have yet to witness any existential crises, such as delistings or bankruptcies.

But the crisis is far from over, as is evident by the hefty discounts at which some BDCs are still trading.[2] The markets and many sell-side analysts alike are expecting that trouble may continue for BDCs through the next reporting period.[3] The fact is that SMEs remain under significant revenue pressure from the pandemic. Consequently, their ability to make loan payments is still an open question, and defaults and delinquencies could have increased during the second quarter of 2020, continuing into the third and fourth quarters.

Consider this one potentially challenging scenario for BDCs: Loan payments drop to the point in which liquidity is insufficient to make required distributions. Loan values drop as a direct result, causing debt-to-equity ratios to exceed the regulatory limits. Efforts to raise additional capital are made difficult, if not impossible, due to below-NAV market values.

Fortunately, that ugly scenario has been pushed off into the distance for many BDCs as a result of strong and swift regulatory relief and persistent signals from central banks that they will do whatever it takes to provide stability for BDCs in the capital markets through the COVID-19 pandemic.[4,5] Those policies have provided meaningful support for the industry. Figure 1 shows that BDC market values remained relatively stable as of March 31, 2020, at about $121 billion. This paper summarizes the key developments on the regulatory front and rounds up some of the accounting matters BDCs may already be thinking about as they assess and respond to the impacts of COVID-19 on their business operations.

Figure 1. Total assets held by BDCs have plateaued since the start of 2020



Source: SEC filings and Deloitte Center for Financial Services analysis, June 2020

SEC reporting update and trends

In March and April 2020, the US Securities and Exchange Commission (SEC) undertook some critical steps to mitigate the impact of the COVID-19 pandemic on BDCs' finances.

Accelerated filer rule

On March 12, 2020, the SEC voted to adopt amendments to the "accelerated filer" and "large accelerated filer" definitions in Rule 12b-2 under the Securities Exchange Act of 1934. Going forward, BDCs with less than $100 million in annual investment income and less than $700 million in public float (as of the second quarter) are no longer considered accelerated filers. Any BDC with less than $75 million in public float would continue to be considered a nonaccelerated filer without a limitation on investment income.

Along with relaxing the timing regarding SEC filings, nonaccelerated BDCs are exempt from auditor attestation on internal controls as required under SOX Section 404(b). However, the final rule does not relieve management of its obligation to establish, maintain, and assess internal controls under SOX Section 404(a).

Who's affected by this? There are about 30 BDCs[6] that may now be able to assume the nonaccelerated status. Those on the cusp of being able to take advantage of this change should weigh certain considerations, such as how the change in filing status would affect their interaction with auditors, as well as with their internal stakeholders and third-party relationships. In addition, BDCs looking to transition to nonaccelerated status should consider past performance, evaluate the current economic outlook, and assess how forecasts for future growth might be affected. While a BDC may be under the thresholds of public float and investment income now, could that answer be different in a year or several years down the road? These are the types of questions BDCs on the bubble need to be asking themselves as a result of this regulatory relief.

SEC's exemptive relief

On April 8, 2020, the SEC issued exemptive relief (Release No. 33837) meant to expand existing coinvestment orders and provide an alternative to calculating asset coverage ratios, giving BDCs immediate temporary flexibility in fulfilling their statutory purpose of providing capital to SMEs.

If a BDC had previously obtained an SEC order permitting coinvestment transactions, the relief allowed further latitude for regulated and affiliated funds (as defined

by the BDC's order) to participate in follow-on investments. For a regulated fund to qualify for the relief, it would have needed to have previously participated in a coinvestment transaction with the BDC in respect to the issuer. An affiliated fund would qualify if it had previously participated in a coinvestment transaction with the BDC in respect to the issuer or is not currently invested in the issuer.

In practice, some BDCs operating as a component of a larger investment manager's strategy were able to capitalize on the expanded coinvestment relief. In addition to the above requirements, the order also requires board oversight and review (by required majority) of coinvestments other than nonnegotiated follow-on investments.

The SEC's relief also provided a relaxation of the asset coverage requirements. Asset coverage requirements are governed by Sections 18 and 61 of the Investment Company Act of 1940. Under normal circumstances, a BDC is required to use asset valuations within a 48-hour period (not including Sundays or holidays) in the calculation.

The exemptive relief offered by the SEC would allow a BDC to use December 31, 2019, valuations if certain conditions existed:

- The BDC held the asset as of December 31, 2019
- The BDC continues to hold the asset at such time of an issuance of debt or sale of securities
- The BDC is not recognizing a realized loss on the asset

The order requires the BDC to make its election on Form 8-K with board approval and includes provisions for continued monitoring and involvement by the board of directors. Further, the BDC may not make a new initial investment in any portfolio company for 90 days. Given these qualifying specifics, use of the exemptive relief has been limited.[7] The exemptive relief is currently being offered through December 31, 2020.

Well-known seasoned issuers

Also, on April 8, 2020, the SEC adopted rules and amendments that go into effect on August 1, 2020, which would allow BDCs to modernize their securities offerings, granting them additional potential flexibility. The new rules allow for certain BDCs to be recognized as well-known seasoned issuers (WKSI), which permits them, among other things, to use automatically effective shelf registration statements rather than have to worry about expiration. BDCs will be able to file short-form registration statements on Form N-2 that will function like Form S-3. The ability to have the shelf registration statement allows BDCs to be more flexible and efficient in the timing and manner in which they raise capital.

SEC valuation proposal

On April 21, 2020, the SEC announced Proposed Rule 2a-5 intending to further clarify the board's role in determining fair value in good faith. Typically, many BDC assets require a good-faith estimate, as they are not publicly traded and there is little market transparency. A BDC board may have a significant involvement in approving valuations, resulting in a blurring of "management" and "oversight."

While the SEC understands that there is no one-size-fits-all approach, the proposed rule looks to further clarify expectations. It would continue to permit the board to directly make determinations of fair value. In addition, it permits the board to delegate or assign this responsibility to the investment adviser, as many do today, subject to additional considerations and oversights.

As we discussed in a full perspective on the proposal shortly after it was released, we reiterate that boards, advisers, and other stakeholders should ask themselves whether the requirements would have helped or hindered the fair value process during the recent period of market stress and disruption before making any changes. The comment period on the proposed rule is open through July 21, 2020.

Asset disposition and acquisition rules

On May 21, 2020, the SEC announced that it had voted to adopt amendments to its rules and forms that were designed to give investors more relevant financial information about businesses acquired or disposed and reduce the complexity and costs to prepare the disclosure.

Before adoption of the amendments, investment companies, including BDCs, followed the same general requirements of Rule 3-05 and Article 11 as other registrants. However, because of the unique characteristics of investment companies, it was often unclear how to apply these rules.

The amendments add SEC Regulation S-X, Rule 6-11, and Rule 1-02(w)(2), which, among other things, provide investment company-specific significance tests and apply to BDCs (1) the investment test, which focuses on the value of the total investments, and (2) the income test, which uses measures commonly included in the investment company's financial statements. This may reduce the number of significant subsidiaries within a BDC's financial statements.

Furthermore, the amendments clarify the financial statement period required to be disclosed in an acquisition involving investment companies (including private funds) if they meet the significance thresholds. The rule requires one year of audited financial statements of an acquired fund and permit those financial statements to be in accordance with US GAAP supplemented by a schedule of investments that complies with SEC Regulation S-X, Article 12.

The amendments also modify the existing requirement regarding pro forma financial information for an acquisition involving investment companies with a requirement to provide certain supplemental information, generally in a more narrative format.

Accounting matters

In addition to keeping up with such regulatory updates, BDCs have had to grapple with accounting demands related to troubled loans and the acquisition of new portfolio companies affected by the COVID-19 pandemic. Here's a quick look at both issues and how BDCs should be thinking about approaching them.

Troubled loans

BDCs will be working with their portfolio companies to assess and respond to the impacts of COVID-19 on their business operations. In certain instances, the portfolio company may have difficulty repaying its debt under the original conditions or default on covenants. BDCs may consider modifying the terms of the loans to further support the portfolio company rather than force a collection through other means.

When a creditor is considering if a loan modification qualifies as a troubled debt restructuring (TDR), there are multiple factors for the creditor to determine if the modification results in a TDR, including whether concessions were made by the creditor to protect as much of their investment as possible or the transfer from debtor to creditor of receivables or assets to fully or partially satisfy a debt. BDCs may also need to assess the collectability of any current or future income accruals and whether the TDR results in a realized event.

Many loans have a cash or payment-in-kind (PIK) option and may move to the PIK option to conserve cash. BDCs should determine whether or not they have a policy on how to recognize PIK income and may need to evaluate exposure to PIK options, even if PIC may have been deemed immaterial in the past.

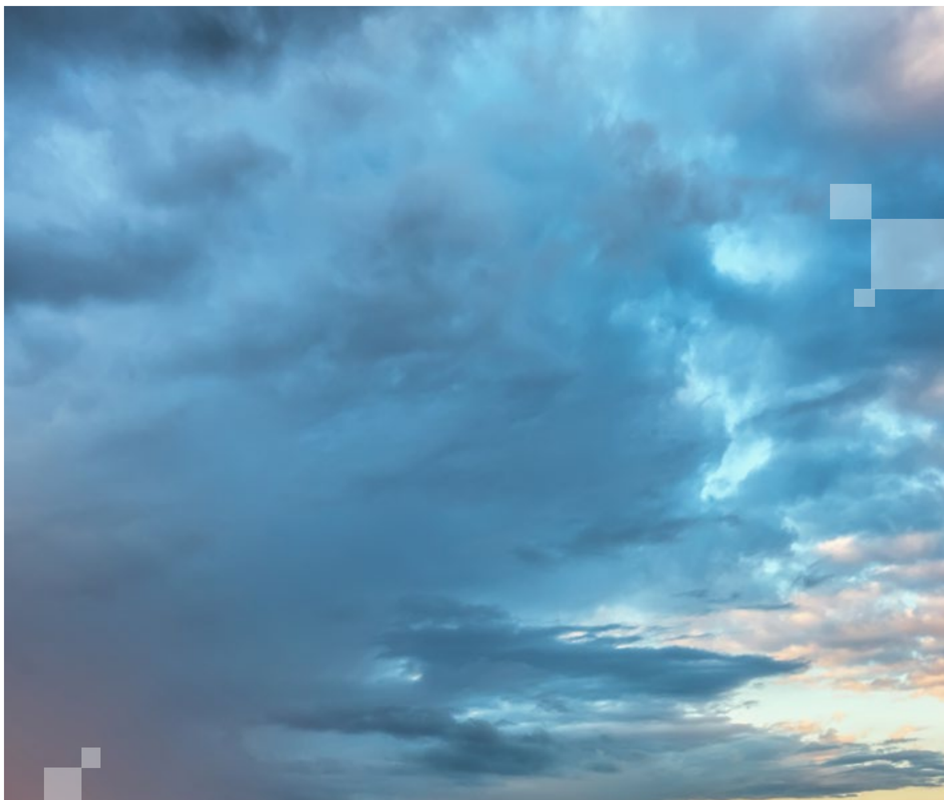
Accounting for a portfolio of loans can provide a list of potential questions and issues, especially in these challenging times when much of the middle market has had significant time of reduced or no operations. How will the portfolio react to the resulting reduced cash flows? Will there be defaults? Will there be requests to restructure? Will there be missed payments? Will cash paying loans with a PIK option move to PIK?

The answer to some or all of these questions for any given BDC will dictate what they will need to do from an accounting, disclosure, and internal control perspective. BDCs will also need to determine if a change in policy is appropriate or whether enhanced monitoring or tweaks to the existing policy are warranted. For instance, would a loan be placed on nonaccrual status if one payment was missed? That could be judged to be too strict a policy in the current environment.

But BDCs can also look to accounting authorities for answers in some cases. One example is in the accrual of interest income when an interest holiday is provided (where the borrower is given a period of time where they are relieved from their interest obligations). In April 2020, the Financial Accounting Standards Board (FASB) received a technical inquiry related to interest income for loan modifications. In the specific instance FASB commented on, the lender provided a loan payment holiday to the debtor to support its business, which was affected by COVID-19. The borrower was able to temporarily stop payments, and interest would not accrue while the holiday was in effect.

The modification did not represent a troubled debt restructuring, but rather is considered a continuation of the original loan. The FASB offered two views on how interest income should be recorded in that case:

- **View 1:** Upon modification, a new effective interest rate in accordance with Subtopic 310-20 is determined that equates the revised remaining cash flows to the carrying amount of the original debt and is applied prospectively for the remaining term. That is, interest income is recognized during the payment holiday period.
- **View 2:** Upon modification, the institution should recognize interest income on the loan in accordance with the contractual terms. Under this view, the institution would recognize no interest income during the payment holiday and would resume recognizing interest income when the payment holiday ends.



Such communications can be helpful when BDCs are in the process of determining how to account for troubled loans and loan modifications in their portfolio arising from the current environment. However, as with the discussion above, there are many factors and decisions to think through, many requiring careful evaluation on a loan-by-loan basis.

BDC portfolio acquisitions, joint ventures, and other potential transactions

Consolidation of assets continues to happen across investment management firms, and BDCs are no exception. The economic downturn may lead to opportunities for acquisitions of entire portfolios or companies, or other combinations, collaborations, and transactions. Many BDCs traded at a discount to NAV prior to COVID-19, and the crisis has only widened these gaps, creating opportunities for consolidation.

The accounting topics regarding mergers and acquisitions can be complex, not only from an accounting and presentation point of view but may harbor tax consequences as well. For those considering growth through acquisitions, many operational, due diligence, accounting, regulatory, and financial reporting hurdles remain. Deloitte is well-positioned to guide your organization from the initial analysis of the target portfolio through the final tax and accounting considerations, financial reporting requirements, and documentation.

Conclusion

The COVID-19 pandemic and its economic repercussions are applying acute pressure on BDCs and their portfolio companies. Regulatory relief has been both timely and difficult to parse. Each proposal under consideration requires astute attention and understanding of how it is likely to affect BDCs at the individual level. In addition, the near-term environment has brought renewed attention to accounting for troubled debt taken out by portfolio companies, as well as the implications for acquisition activities.

Compliance can be a moving target during the best of times, but it’s particularly important to stay abreast of the latest developments during challenging periods. BDCs that are able to stay on top of this rapidly evolving landscape will most undoubtedly emerge more competitive on the other side. The task, for now, is getting through it.

Authors

Clay Chandler
Partner
Deloitte & Touche LLP
cchandler@deloitte.com
+1 609 520 2315

Doug Dannemiller
Senior manager
Deloitte Center for Financial Services
Deloitte Services LP
ddannemiller@deloitte.com
+1 781 217 0547

Ryan J. Moore
Partner
Deloitte & Touche LLP
ryanmoore@deloitte.com
+1 703 251 1874

Sean Collins
Manager
Deloitte Center for Financial Services
Deloitte Services LP
scollins@deloitte.com
+1 617 437 2316

Bryan Johnston
Senior manager
Deloitte & Touche LLP
bryjohnston@deloitte.com
+ 1 609 806 7063

Endnotes

1. Fitch wire, "BDC Unrealized Losses Amid Coronavirus Fuel Leverage, Dividend Risk," Fitch Ratings, May 21, 2020, https://www.fitchratings.com/research/corporate-finance/bdc-unrealized-losses-amid-COVID-19-fuel-leverage-dividend-risk-21-05-2020.
2. Ibid.
3. Ibid.
4. Federal Reserve, "Federal Reserve announces extensive new measures to support the economy," March 23, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.
5. Mitchel Penn, "BDC Thoughts: 2020 is likely to be about credit, liquidity, and capital structure," Janney Montgomery Scott LLC, March 2020.
6. Based on current filing status, net investment income, and public float as of December 31, 2019.
7. Based on 8-K filings at the time of publication.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the "Deloitte" name in the United States, and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.

Copyright © 2020 Deloitte Development LLC. All rights reserved.