Private Business Development Companies – Latest Trends and Market Developments

Private Credit, BDCs & Everything in Between Webinar Series

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Today’s Speakers

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Overview of BDCs

- Special type of closed-end fund created by Congress in 1980 in order to provide small, growing companies with access to capital

- Provides private debt funds and equity funds access to public capital markets

- Operates as a hybrid between an investment company and an operating company

- “Pass-through” tax treatment afforded through regulated investment company (“RIC”) tax status
Significant Regulatory Requirements

- Board of directors is required to be majority independent
- Board must determine fair value of investment portfolio at least quarterly
- Must generally invest at least 70% of total assets in “qualifying assets”
  - Private U.S. operating companies and public U.S. operating companies with an aggregate market value of less than $250 million
  - BDCs must offer to provide significant managerial assistance to these companies
- Leverage limitations – must maintain a 200%/150% asset coverage ratio
- Required to have a chief compliance officer
- Required to adopt and maintain compliance procedures designed to prevent violations of the federal securities laws
Significant Regulatory Requirements (cont’d)

- Must adopt and maintain a code of ethics that outlines standards of conduct for officers and directors and other “access persons” and requires reporting of securities holdings and transactions.

- Subject to restrictions on transactions with affiliates, including co-investments, under the Investment Company Act of 1940 (the “Investment Company Act”), unless granted exemptive relief from the SEC.

- Must comply with bookkeeping and recordkeeping requirements.

- BDCs and their external investment advisers are subject to SEC exams.
Types of BDCs

- **Traded BDCs** - Conduct an IPO either as a “blind pool” fund or after acquiring an existing portfolio
  - Listed on either Nasdaq or the NYSE and have an indefinite lifespan

- **Non-Traded/Continuously Offered BDCs** – Issue up to a maximum amount of their shares in a continuous offering and typically acquire portfolio investments continuously as shares are sold
  - Not listed on a securities exchange, but make periodic repurchases of their shares and generally contemplate a liquidity event, such as an exchange listing, within a fixed time period (e.g., 5–7 years)

- **Private BDCs**
Types of BDCs (cont’d)

What is a private BDC?

- Hybrid between a traditional BDC and a private fund
- Offers shares in private offerings to accredited investors
  - Many private BDCs are sponsored by large private equity/debt shops that have existing investor relationships.
- Offerings are generally conducted through a capital call model, which provides the BDC with flexibility to call committed capital as necessary to make investments.
- Private BDCs typically contemplate a future liquidity event, such as an IPO, a listing on a national securities exchange, a merger, a spin-off or liquidation.
  - Typically there is no liquidity provided prior to the liquidity event, although private BDCs may conduct periodic repurchases.
Explosive Growth in the Private BDC Market

- The first private BDC, BlackRock Capital Investment Corporation (f/k/a BlackRock Kelso Capital Corporation), was launched in 2005.
  - Completed IPO in 2007
- The “current” wave of private BDCs began in 2011, with the formation of TPG Specialty Lending, Inc.
  - Completed IPO in 2014
- Since 2011:
  - Over 25 private BDCs have been launched (of which at least four are now publicly listed)
  - Over $17.5 billion in committed capital has been raised by private BDCs

All information derived from public SEC filings
Who Is Typically Interested in Forming Private BDCs?

- Private equity/debt firms or asset managers that have pre-existing relationships with a base of accredited investors may find the private BDC structure to be appealing.
  - These entities may decide to (1) launch a “blind pool” private BDC with capital calls or (2) conduct a formation transaction to fund the private BDC with assets prior to starting any capital raise.

- Start-up managers unable to conduct an IPO or bear the costs associated with a non-traded public offering may also find the private BDC structure to be an appealing way to raise capital and develop a public track record.
What Are the Advantages of a Private BDC?

- **Flexibility Due to Capital Call Structure** – The capital call structure permits the private BDC to draw funds as investment opportunities arise.

- **Optionality for and in Connection with Liquidity Event** – A private BDC may decide upon the “liquidity event” for its stockholders in the future and can plan to have different fee structures pre- and post-liquidity event.
  - With regard to liquidity events, a private BDC may conduct an IPO, exchange listing, liquidate, or merge with another entity.
What Are the Advantages of a Private BDC? (cont’d)

- **Structural Advantages** – The BDC/RIC structure obviates the need for an offshore feeder fund structure, “season and sell” and similar strategies for foreign and tax-exempt investors.

- **Pass-Through Tax Treatment** – By making an election to be treated as a RIC, private BDCs may benefit from pass-through taxation for U.S. federal income tax purposes.

- **Tax Withholding Advantages** – Non-US investors in a private BDC are not subject to US federal income tax on interest-related dividends or short- or long-term capital gain dividends.

- **Appealing Regulatory and Governance Structure for Investors**
  - File periodic and current reports (Forms 10-K, Forms 10-Q and Forms 8-K) with the SEC
  - Advised by a federally registered adviser (if externally managed)
  - Have a majority independent board of directors
  - Comply with other applicable provisions of the Investment Company Act, including the prohibition on affiliate transactions
Restrictions on Funds Investing in BDCs

- Neither public investment funds (e.g., mutual funds, registered closed-end funds, and BDCs) nor Section 3(c)(1) or Section 3(c)(7) funds (which generally include most hedge funds and private equity funds) may own more than 3% of the outstanding voting stock of a BDC.

- This 3% limitation applies only on a fund-by-fund basis.
  
  - **Upshot**: A fund complex with multiple funds may own in the aggregate more than 3% of a BDC so long as each fund within the fund complex owns 3% or less of the outstanding voting stock of the BDC.

- Pension funds, endowments, and most sovereign wealth funds are not subject to this 3% limitation.
Restrictions on Funds Investing in BDCs (cont’d)

Potential Workarounds to the 3% Limitation for Investing in Private BDCs

- A private investment fund may achieve greater than 3% ownership in a private BDC in compliance with Section 12(d)(1)(E) of the Investment Company Act, which requires that, among other items:
  1. the BDC’s securities are the only investment security held by the private fund; and
  2. the private fund purchases or otherwise acquires the BDC’s securities pursuant to an arrangement with the BDC whereby the private fund is obligated either to:
     - seek instructions from its security holders with regard to the voting of all proxies with respect to the BDC’s securities and to vote such proxies only in accordance with such instructions; or
     - vote the BDC shares held by it in the same proportion as the vote of all other holders of the BDC’s securities.
Launching a Private BDC: General Steps

1. Organization of the entity, typically as a Maryland or Delaware corporation

2. Draft and prepare a private offering memorandum and subscription agreement

3. Prepare and file a registration statement on Form 10 to register a class of equity securities under the Exchange Act, which becomes automatically effective 60 days after filing
   - Subject to SEC review and comment process

4. Negotiate and enter into an investment advisory agreement, which must be approved by a majority of the private BDC’s directors, including a majority of the independent directors, at an in-person meeting

5. Elect to be regulated as a BDC by filing a Form N-54A with the SEC
   - In the event that the private BDC will be populated with existing assets from an affiliated fund, any formation transaction with the affiliate will need to be closed prior to the Form N-54A filing.

6. RIC election to be made at the time of the first filing of a U.S. tax return by the BDC after the BDC commences operations; retroactive effect to the date of the BDC election and effectiveness of the registration statement.
   - RIC must be a RIC for the entire taxable year.
Private Offering and Capital Call Overview

Private Offering

- Conducted pursuant to Rule 506(b) of Regulation D under the Securities Act and sold only to accredited investors
- These accredited investors may include, for example:
  - High net-worth individuals
  - Institutional investors (foreign and domestic)
  - Family offices
  - Pension plans
  - Sovereign wealth funds

Typical Capital Call Structure

- BDC issues capital call notices over time as investment opportunities arise, which committed investors are required to fund pursuant to their subscription agreements
  - At the end of each capital call period, BDC issues shares to each investor based on a purchase price equal to the BDC’s most recent net asset value per share
- Investors who commit to the fund after the initial drawdown are typically required to “catch up” in subsequent drawdowns. This ensures that each investor contributes the same percentage of their respective commitments.
  - Typically adjusted to ensure that subsequent investors contribute their pro rata portion of the BDC’s organizational expenses.
Liquidity Events and Optionality

- **Listing on National Securities Exchange**
  - Requires an effective registration statement on Form N-2

- **Initial Public Offering**
  - Requires an effective registration statement on Form N-2
  - Creates a larger market for the private BDC’s shares than an exchange listing

- **Merger Transaction**
  - Merge with and into an affiliated publicly traded BDC in reliance on Rule 17a-8 without having to first obtain exemptive relief from the SEC, subject to certain conditions, whereas a non-BDC private fund would first need to obtain exemptive relief before merging with and into an affiliated traded BDC
  - Private BDC shareholders must approve any merger
  - Requires an effective registration statement on Form N-14

- **Spin-Off Transaction**
  - Shareholders are given the option to exchange their interests in the private BDC for interests in a newly formed subsidiary, and the private BDC transfers a proportional segment of its assets and liabilities to the newly formed subsidiary.
  - The newly formed subsidiary, which will eventually elect to be treated as a BDC and a RIC, may then conduct a liquidity event, such as an IPO or exchange listing.
  - This structure grants private BDC shareholders the option to remain in the fund or exit via the new public market.
  - Exemptive relief from the SEC is likely needed.
Liquidity Events and Optionality (cont’d)

- May implement a reduced fee structure prior to any liquidity event in order to incentivize initial investors
- Retain discretion to determine which liquidity event is in the BDC’s best interests at a later date, based on the market and other conditions
Evolving Private BDC Structures

- The first private BDCs were designed based on the “traditional” closed-end fund structure and provided liquidity through a public offering; however, the structures continue to evolve to offer investors permanent vehicles with defined future “gates” for exit/entrance.
  - Can build in various options for investor exits at various points in time (e.g., can provide multiple opportunities to move to a liquidating fund or a public vehicle)
- Initial “anchor” investors are increasingly providing input to the investment advisory agreement and may have seats on the BDC board of directors or be granted observation rights.
- There is quite a bit of flexibility regarding structures with the spin-off.
Recent SEC Exemptive Relief for Spin-Off Transactions

- In May 2018, the SEC Division of Investment Management granted an exemptive order for a “spin-off relief” request filed by TCW Direct Lending LLC.

- This is the first exemptive order granted by the SEC to allow a private BDC to offer a liquidity event that would otherwise be prohibited under the Investment Company Act.

- The order permits TCW Direct Lending to offer its investors the option to exchange their interests in TCW Direct Lending for shares of a wholly-owned “Extension Fund” subsidiary, which would seek to conduct an IPO and list its shares on an exchange.

- Because TCW Direct Lending’s investment adviser would be managing both TCW Direct Lending and the Extension Fund, and the Investment Company Act prohibits entities under common control from engaging in certain transactions, relief was necessary to effectuate various parts of the spin-off transaction.

- We expect that additional funds will continue to request relief similar to TCW’s order, some of which will involve creative spin-off strategies.

  • See, e.g., application for exemptive relief filed by Runway Growth Credit Fund Inc. et al. on August 23, 2018 (https://www.sec.gov/Archives/edgar/data/1653384/000114420418046107/tv501596_40app.htm)
About Dechert’s Permanent Capital Practice

Dechert’s multidisciplinary permanent capital team is actively engaged in advising asset managers in all aspects of their capital strategies. We have particularly deep experience in BDCs, having worked with this structure since it was first authorized by law in 1980. We also act for 41 of the top 50 global private debt firms as identified by Private Debt Investor in 2017. Our lawyers possess a detailed understanding of the most current trends and developments, the latest regulatory hurdles, up-to-the-minute market terms and an insider’s perspective when it comes to regulatory compliance. We are committed to turning our experience and expertise into value for our clients.

Save the Date: April 4, 2019 - Permanent & Private Capital Summit in New York, NY

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