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BDCs Provide Capital

AS MORE CAPITAL IS AVAILABLE TO MIDDLE MARKET COMPANIES, M&A MAY HEAT UP

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More financial institutions are establishing business development companies (BDCs), which will likely lead to increased M&A activity as money for acquisitions is available even to small middle-market firms.

Middle market M&A was down in 2013 for the second year, but BDCs should help that volume recover. BDCs should become a meaningful factor in lending because there are more of them and they've gained significantly more assets. By one estimate, today there are 43 traded and 11 non-traded BDCs representing $56.5 billion in assets. In 2000, there were just three BDCS with combined assets of $2.2 billion.

Congress created BDCs in 1980 as an amendment to the Investment Company Act of 1940. The idea was to create a regulated entity to focus on the capital needs of smaller middle market companies. Now, BDCs are here to stay.

Bank lending to smaller companies has become less attractive since the companies have developed low or no debt ratings. Basel III and U.S. banking rules increase the regulatory capital charge for low and unrated assets, making them more expensive to administer. Additionally, illiquid loans are difficult to price, making their valuation subjective--something regulators dislike. BDCs have responded with increasing capital and debt investments.

According to the S&P Leverage Commentary and Data, for the 12 months ended Sept. 30, 2013, traded and non-traded BDCs, raised more than $12 billion. Middle market loan volume also rose year-over-year to an estimated $70 billion, with BDC loan volume representing half of that.

Although all BDCs are different, they tend to provide senior secured/unsecured loans and subordinated debt to small and middle market companies, generally in the range of $10 million to $50 million. BDCs provide capital to middle market companies that have a hard time getting favorable financing from bank lenders or public markets. A 2002 study from the National Center for the Middle Market revealed that 54 percent of middle market companies said access to financing is a challenge.

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Non-bank financing was an estimated 50.4 percent of the overall debt structure for middle market firms, with the smallest firms at 61.3 percent. Banks continue to provide asset-based loans, but are yielding the illiquid, cash-flow-based, term loan market to BDCs.

The critical component for the emergence of BDCs as a major source for M&A financing is the economy itself. As long as economic activity remained sluggish, BDC growth in the merger market was stunted, but there is reason to believe 2014 might be a turnaround year. Inflation is flat. The manufacturing sector continues to improve. Retail sales and the Gross Domestic Product are up. With increasing demand comes a basic decision to expand or acquire. There are numerous opportunities in the economy to consolidate middle market businesses. This, however, will come only when CEOs believe they can build again, rather than just maintain market share. M&A

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