

Private Equity's New Found Admiration for Business Development Companies: The Displacement of Traditional Private Equity Funds

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"We have long thought it inevitable that private equity and mezzanine partnerships would ultimately adopt the BDC structure"¹

In 1980, the United States Congress overwhelmingly passed the Small Business Incentive Act. The purpose of this legislation was two-fold: (i) to eliminate certain provisions and restrictions attenuated with the application of the Investment Company Act of 1940 (the "Investment Act"), which created major disincentives toward private equity investment, and (ii) to create a framework that would encapsulate the flexibility needed to accommodate private equity financing through general public investment. The result? The birth of the Business Development Company ("BDC").

In a nutshell, a BDC is a publicly traded, closed-end investment company, usually formed under the laws of the State of Maryland², which makes investments in small to middle market developing businesses (which generally range from \$10 million to \$100 million in revenue) in the United States in the form of equity capital or long term debt. A BDC offers its investors a high-yield security and, more importantly, immediate liquidation opportunities. In addition, the Investment Act also allows a BDC to, under certain circumstances, issue options, warrants, and other rights to subscribe for voting securities.

To date, very few companies have truly embraced the full gamut of advantages that the BDC organizational structure can offer, but the winds of change are on the horizon. Over the past couple of years, BDCs have captured the attention of both private equity groups and potential investors, and for good reason. BDCs, although saddled with certain drawbacks, provide tremendous opportunities for return on investment and other major benefits to issuers and investors alike.

Source of Capital

In a typical private equity fund, capital, as well as any returns on such capital, is required to be distributed to investors as investments are realized or begin to produce income. In a BDC, contributed capital is retained in the company (sometimes through a dividend reinvestment program) and used for future investment, thereby eliminating the need for future fundraising and the use of the periodic capital call associated with most funds. A BDC is fully funded at the date of its public offering as shares issued to investors are paid for at the time of investment. This permanent source of capital allows the BDC to operate indefinitely rather than liquidating at the end of a five to eight year life cycle.

Diverse Pool of Investors

Generally, private equity funds set high minimum investment requirements. Thus, a substantial portion of the funding comes from high net worth individuals and sophisticated institutional investors such as pension plans, endowments, and foundations. By precluding investment from the retail investment market (i.e. "individual investors"), these funds avoid the burdensome disclosure and registration requirements that generally follow the issuance of securities.

In stark contrast, BDCs provide individual investors access to the private equity market, access that was once a fleeting desire. The public nature of the BDC removes income, net worth, and sophistication requirements. Of significant import is the fact that many of the larger BDCs currently in existence receive a majority of their capital from individual retail investors.

Fees

As noted above, a BDC is fully funded at the close of its initial public offering ("IPO"). This in turn allows managers of the BDC to immediately collect certain management fees, which, on average, range anywhere from 2.00% to 2.50% of the total amount of capital raised in the IPO. In certain instances, a manager of a BDC can double its annual management fee by borrowing funds equal to the company's "net asset" value and calculating the fee based upon the gross assets.

If these fees were not enough, the manager is also permitted to collect a performance/incentive fee of the annual realized gain of the fund. Although the Investment Advisers Act of 1940 generally prohibits registered investment companies from charging performance/incentive based fees, this prohibition does not apply to BDCs so long as three conditions are met:

- the performance/incentive fee cannot exceed 20.00% of the BDC's annual realized gains;
- the fee must be computed "net" of all of the BDC's realized capital losses and unrealized capital depreciation; and
- the BDC cannot have certain types of options, warrants, or rights outstanding or have certain types of profit sharing plans in place

Asset Coverage

Traditional closed-end funds are required to have asset coverage of at least 300% after each issuance. A BDC, on the other hand, is only required to maintain coverage of at least 200% or have an equity to debt ratio of no less than 2:1 (i.e. if a BDC has \$2 million in assets it can borrow up to \$2 million, which would result in assets of \$4 million and debt of \$2 million). In general, these tempered down restrictions allow a BDC greater flexibility in raising equity capital and declaring dividends, while at the same time protecting the public investors with strict limitations on the creation of debt.

Liquidity

For an investor whose sole impetus for investing is near instantaneous liquidity, BDCs are seen as an extremely attractive investment vehicle. The listing of a BDC's securities on a major stock exchange - having an exit pricing available at all times - allows an investor to readily dispose of his securities immediately upon the attainment of a satisfactory profit or at the time a more suitable

investment opportunity becomes readily available; no more will an investor be required to wait until the fund itself liquidates to achieve complete liquidity.

Affiliated Transactions

Traditional closed-end funds are prohibited from engaging in transactions with affiliates who, directly or indirectly, are controlled by the fund itself. That being said, BDCs, while still subject to many of the same prohibitions, have the ability to enter into transactions with affiliates (i.e. provide management and financial services) if the transaction is: (i) approved by a majority of the BDC's disinterested directors, (ii) fair to the shareholders, and (iii) consistent with the collective interest of the shareholders. Allowing the BDC to enter into contractual relationships with certain affiliates streamlines the day-to-day operations of the BDC and directly impacts, in a positive manner, the BDC's overall value-added performance.

To be certain, the structure of the BDC clearly offers significant advantages over the cookie cutter fund structure. That being said, some fund managers have experienced significant drawbacks with the BDC structure, including stringent and often malleable regulatory requirements, which require a BDC to: (i) register its securities under Section 12 of the Securities Exchange Act of 1934; (ii) comply with the Sarbanes-Oxley Act of 2002; and (iii) qualify as a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986.

The current economic climate calls for increased creativity from private equity funds in raising significant capital for investment. On the one hand, the fund structure is a safe, known quantity which has been a successful venture for many years. On the other hand, the BDC opens doors to additional pools of capital once locked to entry. For fund sponsors, BDCs offer unique and important benefits, but are the benefits worth the cost of a strict and uncertain regulatory environment? At this time, it is not clear whether BDCs will succeed in an area where those who have tried before have failed. Raising funds from the public market is not a new and novel idea; this strategy was primarily used (and failed) after the close of World War II. However, if the acceptance of retail investors in the marketplace continues to exponentially increase as it has over the past few years, BDCs may likely prove steadfast and emerge as the investment vehicle of the future.

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1 Malon Wilkus, American Capital Chairman, President & CEO. American Capital is an internally managed, publicly traded buyout and mezzanine fund with capital in excess of \$2.7 billion.

2 The State of Maryland is a popular location for the formation of BDCs due to its "company favorable" laws, which, among other things, protect against unsolicited takeovers and proxy contests.