

Wilshire

Wilshire Business Development

Company Index Introduction Paper

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Business Development Companies Overview

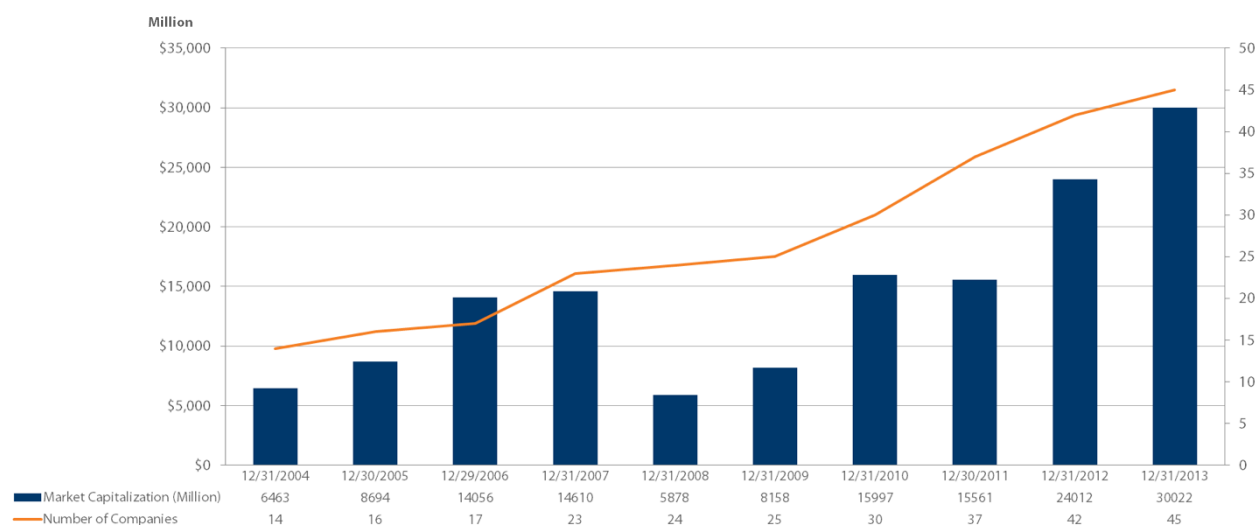
In 1980, Congress enacted the Small Business Investment Incentive Act (“SBIIA”) which, among other things, established Business Development Companies (BDCs) as a new type of closed-end investment company. The purpose was to make capital more readily available to small and developing companies that might not otherwise have access to public capital markets or other forms of conventional financing¹. There are two important U.S. Securities and Exchange Commission (SEC) rules which govern BDCs. First, they must invest at least 70 percent of their total assets in securities of certain, specified types of companies (primarily small- and mid-sized private or thinly traded public companies). Second, they must also distribute at least 90 percent of taxable income as dividends to investors. Additionally, BDCs are regulated under the Investment Company Act of 1940. Similar to real estate investment trusts (REITs), BDCs are organized as registered investment companies (RICs) by the Internal Revenue Service (IRS); however, unlike typical RICs, BDCs are not passive investors given that a BDC is required to make available managerial assistance to the invested companies.

As a RIC, BDCs avoid double taxation by not being taxed at either the corporate level for distributed income or via capital gains. BDCs must maintain low leverage since total debt outstanding cannot exceed total equity. BDCs also typically seek to build a diversified portfolio of investments given that no single investment can account for more than 25 percent of total holdings.

The Business Development Company Market Landscape

It took two decades for the BDC corporate structure to gain traction, fueled in large part by expansion of the private equity industry in the early 1980s. 2004 marked a key turning point for the BDC market, at which time a notable \$930 million IPO for Apollo Investment Corporation (AINV) cemented the BDC as the third largest to date. BDCs provided a means to offer private equity-like investments without the one hundred investor limit. With the exception of the 2008 Financial Crisis, Figure 1 shows the steady increase in BDC companies and industry market values over time.

Figure 1: BDC Market Information



The annualized growth rate for the past five years is more than 13 percent in BDC company count and more than 38 percent in market value.

Business Development Company Business Model

Cursory research may give the impression that these are equity investments with phrases like “a form of publicly traded private equity” and “public vehicles that invest in private equity”; however, BDCs invest in both debt and equity of eligible portfolio companies. Approximately 75 percent of BDCs make a majority of their investments in debt. These investments are usually in the form of short-term notes, which typically range from senior secured debt to unsecured mezzanine debt and which may incorporate derivatives in the \$2 - \$50 million range.

BDCs raise funds for a variety of purposes including investments by issuing a combination of debt and equity. A BDC is permitted to issue multiple classes of debt and one class of stock senior to their common stock of the asset coverage, as defined in the '40 Act. This must be at least equal to 200 percent immediately after each issuance. BDCs compete with various sources of capital, including private equity funds, hedge funds, investment banks and other BDCs, to provide financing to small businesses. It is then up to the BDC to manage the cost of borrowing (usually fixed) with the income from lending (most often a combination of high interest rates or variable rate with a significant margin).

Business Development Company Interest Rate Exposure

The BDCs that focus on debt security investments create a relatively stable dividend payout by managing the cost of borrowing with the rates they charge on their investment terms. Unlike a generic bond portfolio, the BDC general business model of borrowing at a fixed rate and lending at a higher, or variable rate is protected against inflation and setting a floor if interest rates go down. Some BDCs explicitly address this in the SEC filings. Figures 2 and 3 show 10-Q excerpts about market risk for two of the larger Wilshire BDC Index companies.

Figure 2: Ares Capital Corporation *(in millions)*

Basis Point Change	Interest Income	Interest Expense	Net Income (1)
Up 300 basis points	\$112.8	\$11.9	\$100.9
Up 200 basis points	\$50.0	\$7.9	\$42.1
Up 100 basis points	\$(11.5)	\$4.0	\$(15.5)
Down 100 basis points	\$6.8	\$(0.6)	\$7.4
Down 200 basis points	\$6.8	\$(0.6)	\$7.4
Down 300 basis points	\$6.8	\$(0.6)	\$7.4

Source: Form 10-Q June 30, 2014

Figure 3: Apollo Investment Company *(in thousands except per share data)*

Basis Point Change	Net Investment Income	Net Investment Income Per Share
Up 400 basis points	\$11,248	\$0.048
Up 300 basis points	\$5,673	\$0.024
Up 200 basis points	\$(12)	\$0
Up 100 basis points	\$(3,639)	\$(0.015)

Source: Form 10-Q June 30, 2014

Wilshire Business Development Company Index Construction

The Wilshire Business Development Company IndexSM is focused on BDCs that specialize in debt investments and is therefore designed to capture risk exposures of the typically high yield, small debt investments within these BDC portfolios. Bond investors typically continue to expand their search for higher debt-risk opportunities by extending durations, lowering quality, rediscovering junk bonds or investing in the current rage—bank loans. The Wilshire BDC Index aims to provide a liquid, diversified way to measure bank loan type risk and performance.

Membership for the Wilshire BDC Index begins with the Wilshire 5000 Total Market IndexSM (Wilshire 5000[®]), which includes all publicly traded U.S. securities with readily available prices, as a baseline. The Wilshire 5000 maintenance rules then govern investability rules such as: being dropped if a security is delisted from the major U.S. exchanges, NYSE or NASDAQ; stops trading for more than ten consecutive trading days; or, doesn't trade for 20 business days in a quarter. The expectation for inclusion is that the security will trade every U.S. trading day. The Wilshire 5000 rules also govern treatment of changes to float and shares outstanding. Float and shares outstanding are made on the quarterly, calendar rebalance date unless the cumulative adjustment is greater than ten percent. Lastly, the Wilshire 5000 rules also govern treatment of corporate events such as splits, dividends and mergers.

Then, once a quarter, the universe of BDC securities is created by extracting those Wilshire 5000 companies that have filed with the SEC as a BDC companyⁱⁱ. Wilshire staff review each BDC company's SEC financial filings (10-Ks and 10-Qs) to identify the company's investment ratio in debt financing of "eligible portfolio companies" (i.e., small, unlisted U.S. companies). The types of debt utilized include, but are not limited to: senior debt, second lien debt, secured and unsecured subordinated debt, mezzanine debt, bullet maturity debt and revolving credit. BDC companies with more than 75 percent debt investments and market capitalization greater than \$100 million are eligible to be added to the index, while those with less than 50 percent of their investments in debt or market capitalization below \$50 million for a second quarter are removed.

The resulting Wilshire BDC Index is designed to provide a liquid, market-valued, proxy for bank loan type investments.

The Search for Yields

Both equity and fixed income investors have increasingly been attracted to high yield investments. Equity vehicles accomplish this directly with dividend- or yield-weighted indices, or indirectly with traditionally high yield market segments such as utilities, limited partnerships and REITs. REITs are not only required to pay high dividends, but are also taxed like RICs such that in order to avoid corporate taxes they must pay at least 90 percent of their taxable income to investors. One challenge with dividend- or yield-weighting is high turnover cost. An additional challenge with the equity market segment approach is too much concentrated risk exposure to a section of the market: utilities, energy and real estate, respectively. Bonds are either issued with a large coupon (i.e., high yield), or credit worthiness of the bond has reduced its price to a level that makes the coupon a high yield percentage of the investment. BDCs in the Wilshire BDC Index combine the best of both worlds to address these two challenges. Wilshire BDC Index companies do due diligence for the investment notes, many of which have equity conversion provisions. The BDC is expected to, and does, provide management assistance to the company. This high yield is a result of the size of the notes, the size of the company and its inability to raise capital on the open market. Given that BDCs are not tied to any single business segment, their investments are in small companies not tied to any one industry. This makes a collection of BDCs, such as the Wilshire BDC Index, diversified across industries.

Figure 4: Yield Comparison

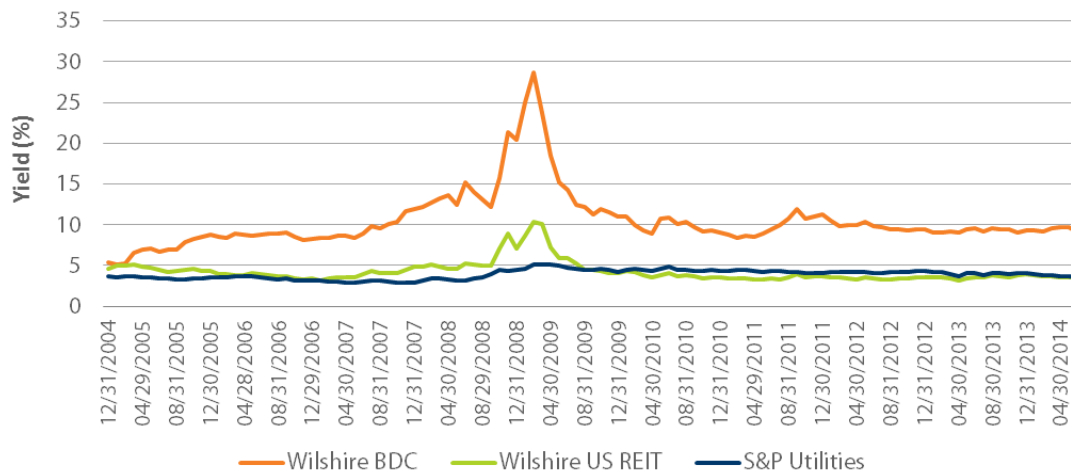
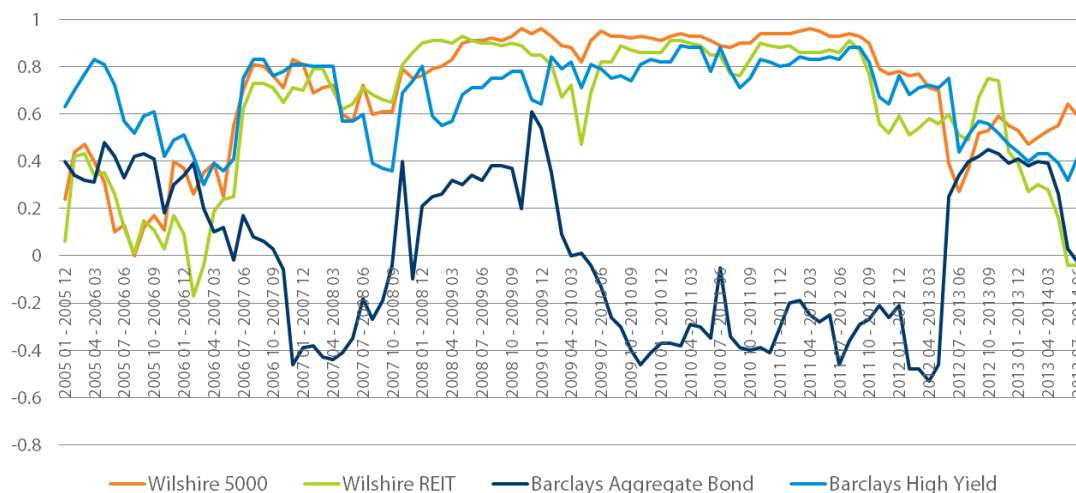


Figure 4 illustrates the consistently, relatively high yield of the Wilshire BDC Index versus other market measures known for their high yield.

Performance Correlations

The Wilshire BDC Index combines both equity and bond performance drivers, so it is not surprising that Figure 5 demonstrates medium return correlations to both high yield equity and high yield debt.

Figure 5: Correlations to Wilshire BDC Index



Given that BDCs are publicly traded companies investing in private markets, BDCs could be viewed as a bridge between the public equity and bond markets to the private equity and bond markets.

Summary

Business Development Companies are a rapidly growing segment of the U.S. equity market. They provide tax- advantaged access to private market investments via liquid securities that trade on U.S. exchanges. The Wilshire BDC Index is designed to capture the risk characteristics and performance of the BDC market that specializes in debt investing, which aims to capturing high yields with bank loan-type risk that is actively managed for protection against inflation.

For more information go to: www.wilshire.com

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ⁱ U.S. Securities and Exchange Commission press release, “SEC Adopts New Rules for Business Development Companies and Repurposes New Category of Eligible Portfolio Company”, 2006-181

ⁱⁱ BDC companies file a form N-22 with the SEC.