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TPG Specialty Lending and TICC Capital prove price cures price for BDCs too

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TICC Capital Corp. may prove the market adage "price cures price" correct yet again. As I have noted in prior posts on business development companies, the past year has entailed varying degrees of brutality from a price perspective for many BDCs.

As of September 17, the SNL U.S. RIC index had declined about 20% since June 30, 2014, when credit spreads began to widen. A year ago many BDCs traded in the vicinity of book value, or net asset value. Today, most trade at discounts that range from modest to sizable in spite of dividend yields that range into the high teens. I think the market is expressing its view that asset values and dividends for many BDCs will be lower in the future. But, the money question is this: do BDC share prices fully reflect further cuts? If so, the margin of safety may be okay for new money.

BDCs, described as publicly traded private equity by some, are publicly traded credit funds that employ a moderate amount of leverage to fund the assets. BDCs are income plays because at least 90% of taxable earnings must be distributed as regulated investment companies. The past decade has seen significant growth for the industry. Banks have pulled back from lending to highly levered companies, credit spreads narrowed between late 2008 and mid-2014 and investors gave boatloads of capital to existing and newly formed BDCs in search of yield. The situation is trickier now. The past year has seen credit spreads widen, NAVs decline and some dividend cuts. Nevertheless, nonperforming assets are low for most BDCs. Go figure.

TICC is reasonably representative of the group. Its book value was $8.60 per share at June 30, down 11% from $9.71 per share a year earlier. Its shares fell 32% year over year to $6.72 on June 30, which equated to a price-to-book multiple of 78%, compared to 102% a year earlier. The dividend has not been cut, but a yield in excess of 16% implies the market expects a cut. TICC also has a sizable investment in CLO equity with about 29% of its $956 million portfolio allocated to the asset class.

CLO equity is a mystery meat in terms of value. Creditflux — citing a Morgan Stanley report — notes that median US CLO equity NAV declined about 9% in August and is now 47%, down from 70% in May. On September 11, Creditflux reported that controlling blocks of CLO equity struggled to trade in the secondary market. BDCs with sizable CLO equity positions such as TICC and Prospect Capital Corp. have seen more pressure on their shares than those without material exposure.

If price cures price, TICC's share price fell enough to attract one deep-pocketed investor. On September 16, TPG Specialty Lending Inc. disclosed an unsolicited offer it made for TICC a few days earlier. TICC's board so far has brushed off the offer, in which TPG would acquire TICC for $7.50 per share consisting of TPG stock. The proposed price equated to a 20% premium to TICC's closing share price of $6.27 per share on September 15. TICC's stock closed at $7.01 on September 17.

If my math is correct, TICC shareholders face a dividend cut based upon the current proposal that implies an exchange ratio in the vicinity of 0.434 TPG shares ($7.50 / $17.29). The pro-forma dividend to TICC shareholders would be 68 cents per share based upon TPG's annualized quarterly dividend of $1.56 per share. TICC's annualized quarterly dividend is $1.16, but the market obviously has its doubts about the sustainability of the dividend. If not, the shares would trade closer to book value with a yield in the low teens.

Assuming TPG management has not grossly misjudged TICC's asset value, they deserve praise for being quick on their feet to press a valuation advantage to potentially unlock value for both companies' shareholders. TPG is less levered than TICC, the bulk of its investment portfolio consists of senior secured loans (to levered companies) and the dividend has not been cut. As a result, TPG is among the minority of BDCs that trades above book value at 109% as of September 17. The proposed purchase price of $7.50 per share equates to 87% of TICC's book value as of June 30, resulting in accretion to TPG's pro forma book value per share.

There is one additional wrinkle to TICC that applies to all externally managed BDCs — fees paid to the management company. Some think the fees are high if not exorbitant for what amounts to levered bond portfolios. Fees tend to be in the vicinity of 2%, plus an override if certain performance benchmarks are met.

TICC's management company, TICC Management LLC, has agreed to be acquired by an affiliate of Benefit Street Partners LLC. The acquisition was announced in early August. Since then, NextPoint Advisors has entered the fray by proposing a different slate of directors and a management agreement that would reduce the base fee to 1.25% from 2.00%. Benefit Street's revised proposal, which the TICC board has affirmed, entails a lower fee too. Given the fees, I am surprised more credit managers have not made a run at BDC boards to move the management contract.

TPG presumably has a fee angle too, but it is offering TICC shareholders a premium today and a promise to shift TICC's portfolio into credit investments that have a better risk/return profile. TPG also indicated if it cannot find such investments, then accretion to its NAV from the transaction would be returned to shareholders. Translated, it is management's way of saying they do not intend to do anything stupid with the extra capital that is the result of the valuation arbitrage.

Does the math imply TPG low-balled TICC? Not necessarily. The critical questions for TICC: what are the assets worth, especially the CLO equity, what is the outlook for TICC's dividend paying capacity if the company remains independent and how does that compare with an investment in what would be a much larger TPG? Maybe with the Fed unwilling to raise rates CLO equity will catch a bid. In any event, TPG sees value that public market investors do not.

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