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NASHVILLE NOTES

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NAV: literal or in the ballpark Gospel?

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The fight over TICC Capital Corp. probably is not a showdown that has caught the attention of too many investors. Maybe it should. It involves some of the issues that I and others have raised over the past year about the sustainability of dividends paid by BDCs as zero interest-rate policy drags on; pressure on net asset value as credit spreads widen; manager performance and exorbitant management fees paid to external managers. Because BDCs' primary shareholders are income-focused retail investors rather than institutional shareholders, there has not been too much hell-raising even though most BDC shares have performed poorly for over a year. TICC's shares have declined 34% from June 30, 2014, through October 22, 2015.

I am not sure how TICC's analysts feel about the issues. One lesson I learned at J.C. Bradford & Co. as a sell-side analyst is that when dealing with retail you can be wrong about equity and be forgiven. If you are wrong about a bond that retail piles into, you lose your job. BDCs are moderately levered credit funds. BDC equity is more akin to owning the equity tranche of a structured credit product than common equity in an operating company. Also at least 90% of taxable income must be paid to shareholders, given the regulated investment company (RIC) status under the tax code.

I do not know if anyone is going to be fired over TICC's performance. Its path forward may be resolved on October 27 if shareholders approve a company-backed plan for Benefit Street Partners LLC (BSP) to acquire TICC's current manager, TICC Management LLC. The result will be lower management fees and a change in investment strategy that will emphasize BSP-sourced deals over syndicated leverage loans and CLO equity.

Also, BSP has proposed a plan in which the company will tender for $50 million to $100 million of TICC shares at a minimum price of 90% of net asset value. TICC closed at $6.49 per share on October 22, which equated to 76% of June 30 NAV (or book value) of $8.60 per share. The implied tender offer would be about $7.75 per share unless NAV declines. One might ask why TICC cannot implement the repurchase without BSP, in addition to leaning on the current manager to cut its fee.

If capitalism, like justice, is an idolized concept but imperfect reality, I think we can take solace in how the TICC story has played out so far. The high fee charged by TICC's current manager and the poor performance of its shares since credit spreads began to widen in June 2014 have produced alternatives for shareholders in addition to the BSP deal.

NexPoint Advisors LP has put forth a slate of directors and has proposed that an affiliate assume the management of TICC at less cost than the current manager charges. TPG Specialty Lending Inc. has proposed to acquire TICC for $7.50 per share with consideration consisting of TPG common shares. If shareholders reject the TICC/BSP proposal that does not mean a deal with NexPoint or TPG will occur; however, rejection seemingly would put pressure on TICC to start talking.

What are the outcomes of TICC being put in play? One is that management fees probably will decline. BSP's and NexPoint's offers entail lower fees than what TICC Management is charging. TPG's fee structure is uncertain, though it seems like a structure comparable to BSP or NexPoint should be an easy card for TPG to play to sweeten its offer if shareholders reject the TICC/BSP proposal.

Another outcome is a probable reduction in the quarterly distribution of 29 cents per share. It equates to a 17.9% yield. The market is signaling a cut is likely given the high yield. Also, widening credit spreads for over a year point to emerging corporate credit issues in 2016 and 2017, absent a pick-up in economic growth. If so, that would be especially impactful for CLO equity because it is the bottom tranche in the capital structure used to finance portfolios of leveraged loans. TICC's CLO equity portfolio on a fair value basis totaled $276 million at June 30, which approximated 29% of the $956 million investment portfolio and 54% of net assets of $516 million. The CLO book is high yielding. Its 2Q15 cash yield determines taxable income was 25.4%, which resulted in core net investment income of 32 cents per share, compared to 18 cents per share on a GAAP basis.

As I noted in a recent post, CreditFlux reports that CLO equity has struggled in the secondary market in terms of market-clearing bids. Perhaps that is one reason TICC's board is backing the BSP takeover because BSP has proposed transitioning the portfolio out of CLO equity. NexPoint intends to continue the current investment strategy, noting in an Oct. 20 presentation that its track record of investing in CLOs and leverage loans is much better than industry benchmarks. TPG's current strategy does not include CLO equity; however, a dividend cut would occur with TPG because the implied exchange ratio of 0.43 TPG share for each TICC share and TPG's annualized dividend of $1.16 per share equates to 67 cents per TICC share. The net is that regardless of the outcome on October 27, a dividend cut seems likely to me.

And what about NAV? Are TICC shareholders shortchanged if the company is sold to TPG for $7.50 per share when its NAV was $8.60 per share at June 30? NexPoint called TPG's $7.50 per share offer "inadequate" because it represented a 13% discount to June 30 net asset value. Ares Capital Corp. Kipp deVeer opined that the TICC situation was a "mess" and that management should be fired if it went to the board with a proposal to sell the company for less than NAV after going to the board quarter after quarter to tell them what NAV is.

Is NAV literal unerring gospel, or is it an estimate that is in the ballpark based upon management's and the board's assessment of fair value? Wells Fargo analyst Jonathan Bock asked Prospect Capital Corporation management during February this year if they could liquidate the CLO equity book at its fair value mark. Management responded that it would want to liquidate the book at that mark.

Want to and *can* are two different things. Fair value is guided by FASB ASC 820. It is the accounting standard for fair value, which defines value as the price received upon selling an investment in an orderly transaction to an independent buyer. It is a subjective process that involves assumptions about market conditions, multiples for comp companies, cash flows, appropriate discount rates and the like. When markets are trending higher as was the case from 2009 to mid-2014, it is an easier process.

It is a tougher process now because credit spreads have been widening for over a year and liquidity in the leveraged loan and high yield bond markets has declined. The option adjusted spread on Bank of America/Merrill Lynch's B-rated high yield index widened to 6.80% at September 30 from 5.03% at June 30. Stated differently—high yield bond prices fell. Closed-end funds Oxford Lane Capital Corp. and Eagle Point Credit Co. Inc., both of which primarily invest in CLO equity, have seen pronounced declines in their shares since mid-2015. Eagle Point announced on October 14 that it expects NAV to be $15.76 to $15.86 per share as of September 30, down roughly 15% from $18.62 per share at June 30. Eagle Point has made such no announcement, although recent price action implies that may occur. As of October 22, Eagle Point closed at 92% of June 30 NAV and Oxford Lane closed at 81%. Like high dividend yields that point to eventual dividend cuts, I believe the market is telling us that NAV is headed lower for credit funds.

NAV is an informed estimate. Sometimes market conditions produce an estimate in which there should be a high degree of confidence; at other times there is less confidence. In light of widening spreads for high-yield credit and CLO equity that has struggled to trade, I believe TICC's and maybe most BDC's NAV will decline this quarter. The market has telegraphed as much given the performance of the sector this year. It may be that TPG's offer will look more generous in terms of NAV once September 30 NAV is reported.

One other note. Timing matters. CLO equity has been a bad place to be the past year or more in terms of impact on NAV. Maybe selling to TPG would represent bad timing too if credit spreads have begun a sustained reversal that eventually takes CLO equity prices higher as investor confidence in future cash flows increases. Under that scenario TICC shareholders presumably would see NAV rise if Nextier was managing the fund because Nextier plans to keep the same investment strategy. Maybe that could be true too with BSP and TPG if either were successful and took a year or more to transition TICC's portfolio. Those are what ifs. The yes but is that TPG has made a proposal—albeit non-binding—to acquire TICC for a price that represents a 16% premium to TICC's October 22 closing price of $6.49 per share. Also, the proposed acquisition price probably will be at a smaller discount to NAV once September 30 NAV is released than June 30 NAV of $8.60 per share. If shareholders reject the BSP deal, maybe TICC will counter with a still lower fee for Nextier and a combination of a lower fee and higher acquisition price with TPG.

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