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Non Accruals rise, not spike; Lower middle market BDCs steady at 7.5%

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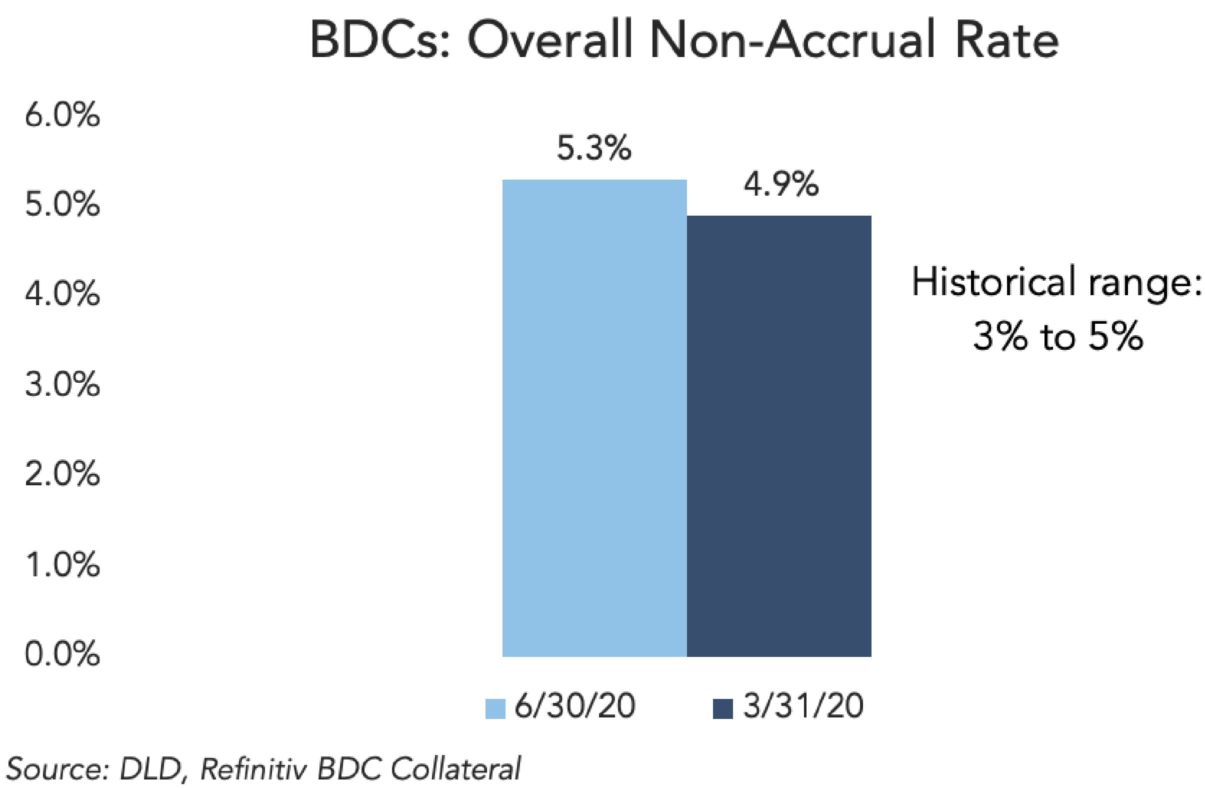
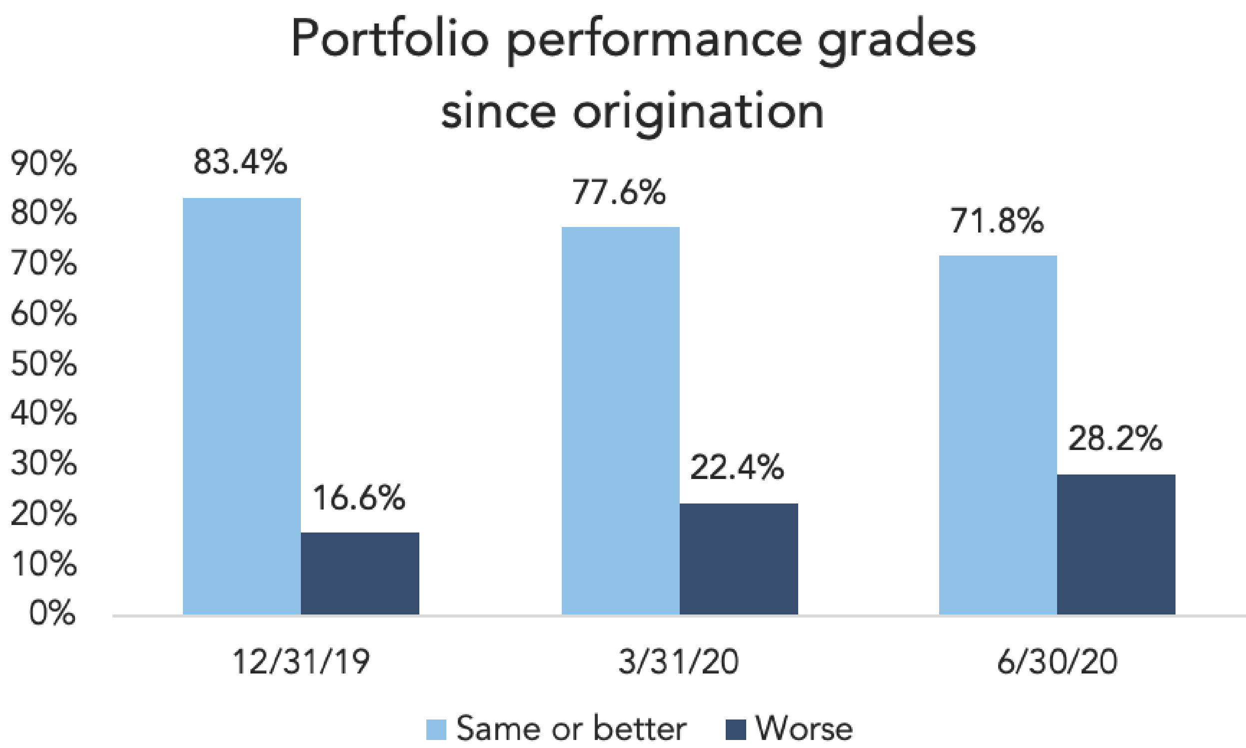
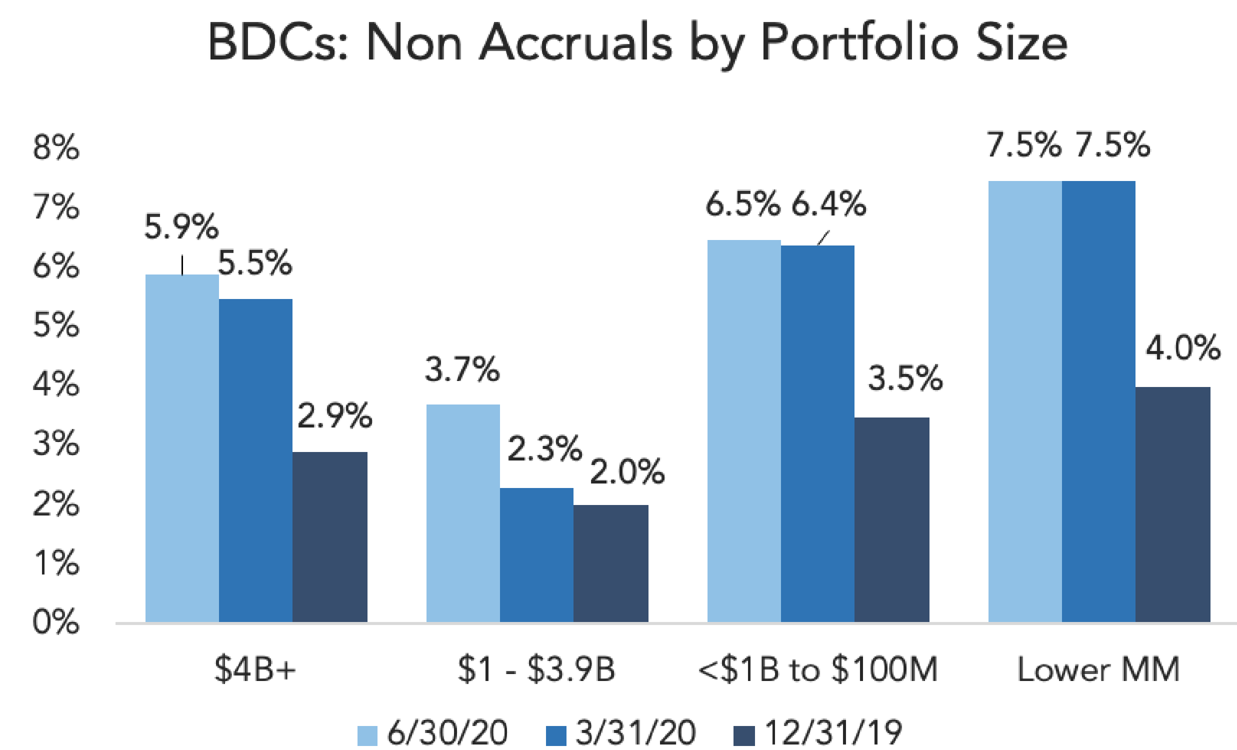




Source: Wells Fargo Securities



Sources: DLD; Refinitiv BDC Collateral

BDC non-accruals rose to an average of 5.3% at June 30, up from 4.9% at the end of March, based on a DLD analysis using Refinitiv's BDC Collateral database. Last quarter's increase hoisted the average above the historical range of 3% to 5% for the first time since the Great Recession.

Even so, the rise wasn't the spike many had feared after months of Covid closures. Equity injections and waivers kept worse-case scenarios from playing out, and some lower middle market companies were able to tap relief funding.

(See chart I)

At **Ares Capital**— the largest single BDC with $13.8 million in investments— the team worked through 40 amendments during the quarter on about $2 billion of fair value, management said on last month's earnings call. **Golub Capital**'s management said they executed more than 50.

Several managers said that most amendments were short-term in nature and did not require years of relief. Amendments also allowed for pricing increases and tightening of other terms, they noted.

Non-accruals are expected to continue trending higher as the pandemic recovery plays out.

Keefe Bruyette & Woods noted in a recent research note that watchlist investments declined, but many challenged companies will continue to need additional capital and/or restructuring.

More investments moved into higher risk categories across internal grading methods. Nearly a third of the companies in portfolios covered by **Wells Fargo Securities** are performing worse since origination, compared to 22.4% at March 31 and 16.6% at December 31, 2019.

(See chart II)

DLD broke down all BDCs* into four categories to look at non-accrual rates based on portfolio size and strategy. Those focused on the lower middle market had the highest non-accrual average, as one might expect. Every group had their outliers.

(See chart III)

>$4B: Average 5.9%
The average non-accrual rate in this small group of six jumbo BDCs rose to 5.9% in 2Q, up from 5.5% in 1Q. Ares Capital is the largest, with **Owl Rock Capital** bringing up second place at $9.2 billion.

The 5.9% rate is marred by **FS KKR Capital I** and **II**, which had rates of 9.9% and 11.15%, respectively. Toss these out, and the average drops to 3.5%.

The BDCs in this group typically employ multiple strategies that target upper middle market borrowers and go beyond first-lien debt. Weighted average EBITDA in the Ares portfolio, for example, is $140 million, and 30% of the portfolio is invested in second-liens. Average EBITDA in Owl Rock's portfolio is $93 million, and second-liens account for 16% of investments.

<$4B to $1B: Average 3.7%
This group holds 23 BDCs that had an average non-accrual rate of 3.7%. Taking out **FS KKR Energy & Power**'s 25% rate drops the average to 2.7%.

About 75% of this group had a 2Q non-accrual rate of less than 5%. **Owl Rock Technology Group** and **Solar Capital** were at zero.

<$1B to $100M: Average 6.5%

Nearly half of all BDCs —both public and private—fall into this category. The second quarter average ticked up to 6.5% from 6.4% at March 31. **Medley Capital** is this group's outlier, at 28%. Without Medley, the 2Q rate would have been 6%.

Lower Middle Market: Average 7.5%

This group has 11 BDCs, with an average rate of 7.5%. It's the highest of the four categories, but also held steady over the first quarter. **Harvest Capital** has the highest rate: 19.2%. Without it, the average drops to 6.3%.

**BDCs with less than $100M in investments were excluded. All non-accrual rates in this analysis are based on cost.*