

Why We Invested in Great Elm Capital Notes

This article by Jim Roumell is excerpted from a letter of [Roumell Asset Management](#).

Great Elm Capital Group is a publicly-traded business development company (“BDC”) that seeks to generate both current income and capital appreciation through debt and equity investments. The investment focus is on debt obligations of middle-market companies. Great Elm invests primarily in the debt of middle-market companies, as well as small businesses, generally in the form of senior secured and unsecured notes, as well as in senior secured loans, junior loans and mezzanine debt. From time to time, the company will make equity investments as part of restructuring credits and, in rare instances, make equity investments directly.

The 6.5% notes [unsecured, due 9/18/22, GECCL], purchased at par, are a new issuance of notes. The notes will mature on September 18, 2022 and pay interest quarterly, beginning October 31, 2017. Great Elm may redeem the notes in whole or in part at any time on or after September 18, 2019, at its option, at par plus any accrued and unpaid interest. Great Elm disclosed that it will use the net proceeds from this offering to repay outstanding indebtedness under its 8.25% notes due in June 2020.

Regulatory restrictions under the Investment Company Act of 1940 limit the amount of debt that a BDC can have outstanding and brings us a great deal of comfort that our notes are well protected by significant, and persistent, asset coverage. Generally, a BDC may not issue any class of indebtedness unless, immediately after such issuance, it will have asset coverage of at least 200%. For example, if a BDC has \$1 million in assets, it can borrow up to \$1 million, which would result in assets of \$2 million and debt of \$1 million. If Great Elm were to breach this regulatory limit it would be forced to take action to come back into compliance. The company would not be able to pay any common stock dividends until it was in compliance. These actions could include the sale of assets and repayment of a portion of the debt or the issuance of new common equity, all of which protect us as bondholders. *We are unaware of a BDC-issued bond having ever defaulted.*

In addition to the 1940 Investment Company Act debt limit restriction, there is a built-in incentive for the BDC manager to maintain a leverage ratio significantly less than the allowed 200% level. Because BDCs are locked-up money, the contract to manage the assets is very valuable. Thus, the disincentive to cross the line, and risk losing the contract, is quite high. The median net debt/equity ratio of Ladenburg Thalmann’s BDC coverage universe is 0.57x indicating BDCs operate well within the 1940 Act leverage restrictions. As referenced earlier, with over 50% of ten-year rolling periods for the S&P 500 failing to generate an 8% annualized return, securing a no-frills 6.5% return on a portion of our capital is an attractive investment, in our opinion.