

## Fitch Affirms Fifth Street's Ratings at 'BBB-'; Outlook Stable

Written by Australian Business

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CHICAGO--( [BUSINESS WIRE](#) )--Fitch Ratings has affirmed the Long-term Issuer Default Rating (IDR), secured debt rating, and unsecured debt rating for Fifth Street Finance Corp. (FSC) at 'BBB-'. The Rating Outlook is Stable.

These actions are being taken in conjunction with a broader industry review, which includes seven business development companies (BDCs), and coincides with the publication of an industry report: 'Business Development Companies - A Comparative Analysis: 2014', which is available on Fitch's website.

### KEY RATING DRIVERS

The rating affirmations reflect FSC's experienced management team, ready access to deal flow with various sponsor relationships, relatively stable core operating performance, solid asset quality, improved funding flexibility, increased dividend coverage, and the maintenance of leverage levels within management's internal target.

The rating are constrained by FSC's lack of operating history through a cycle, outsized portfolio growth, and potential execution risks associated with new business verticals. Additionally, ratings are constrained by the capital markets impact on leverage -- given the need to fair value the portfolio each quarter -- dependence on the capital markets to fund portfolio growth and a limited ability to retain capital due to dividend distribution requirements.

FSC's core operating metrics remained strong through fiscal 2013 and 1Q'14, as higher origination activity offset lower investment yields and higher costs. Total investment income produced an annualized yield of 13.6% on the portfolio for the period ended Dec. 31, 2013. Fitch believes net investment income will increase through the remainder of 2014 as portfolio growth outpaces repayments and yields on new originations begin to stabilize. Still, outsized portfolio growth in the current competitive credit environment is viewed cautiously by Fitch.

During 2013, FSC announced it was entering into venture lending through Fifth Street

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Technology Partners (FSTP) and announced it was entering the aircraft leasing sector with the formation of its new portfolio company, First Star Aviation LLC (First Star), which is owned by FSC. First Star accounted for 1.9% of the investment portfolio at value at December 31, 2013.

Fitch believes the new asset classes have the potential to generate attractive risk-adjusted returns; however, this will depend on FSC's ability to be selective, given the competitive environment. Both segments are highly competitive, but this is partially mitigated by the fact FSC has hired experienced management teams in the relative verticals to manage the business. Fitch does not expect these verticals to account for a meaningful portion of FSC's portfolio.

Asset quality remains solid, with no investments on non-accrual status at December 31, 2013.

Leverage, as measured by debt to equity, including Small Business Administration (SBA) debt, amounted to 0.77x at December 31, 2013, up from 0.47x a year earlier, and within management's long-term targeted range. Fitch expects leverage will be held relatively constant during the remainder 2014 as new originations are funded through portfolio investment sales. FSC believes it has ample opportunity to sell down some of its larger positions to generate proceeds for new investments.

In February 2014, FSC became the third BDC to access the institutional unsecured debt market since the financial crisis when it issued \$250 million of five-year notes with a 4.875% coupon. Fitch views FSC's access to this market positively as it diversifies the company's funding sources and adds additional financial flexibility. Unsecured debt accounted for 26.3% of total debt outstanding at Dec. 31, 2013.

FSC's liquidity profile remains strong with \$42.6 million of balance sheet cash and \$186 million of availability on its secured revolving facilities, subject to borrowing base requirements, at Dec. 31, 2013.

On Nov. 25, 2013, FSC announced it was cutting its monthly dividend to \$0.0833/share from \$0.0958/share in an effort to align the dividend with net investment income

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expectations given the low yield environment, which Fitch viewed as prudent. FSC's net investment income per share during the quarter ended December 31, 2013, was \$0.26 per share, and the company paid \$0.24 per share in cumulative monthly dividends. Going forward, FSC has declared monthly dividends through August 2014 of \$0.833 per share, or a \$0.25 per share quarterly run rate. Fitch views sustained net investment income coverage of current-period dividend declarations favorably.

The Stable Outlook reflects Fitch's expectations for relatively consistent operating performance in 2014, as portfolio proceeds are redeployed into cash-yielding investments with attractive risk-adjusted returns, and sustained dividend coverage from net investment income.

Fitch sees a number of emerging industry challenges that could pressure ratings, or at least increase rating differentiation amongst BDCs over a longer-term horizon. These challenges include a potential increase in regulatory leverage limits and increased competition, which are yielding tighter market spreads and looser underwriting terms, including higher underlying portfolio company leverage and weaker covenant packages. Should competition continue to intensify, market yields could decline further, which would reduce earnings generation and pressure dividend coverage for the space.

### RATING SENSITIVITIES

Positive rating momentum could be influenced by a larger unsecured funding component, strong and stable cash earnings coverage of the dividend, and FSC's ability to successfully execute on its aircraft leasing and venture lending verticals over an extended period of time, as well as continued strong performance from asset-backed lender HFG Holdings, LLC, which is currently FSC's largest portfolio investment. Additionally, consistent operating performance through market cycles and the maintenance of solid asset quality would be viewed positively.

Negative rating action could be driven by continued outsized portfolio growth, an overly aggressive rate of expansion into new business verticals and/or meaningful portfolio concentration within these verticals, a decline in operating performance, or a deterioration in asset quality. Additionally, an increase in leverage above the targeted range, resulting from material unrealized depreciation, and/or an increase in the proportion of equity holdings without a commensurate decline in leverage would be viewed unfavorably.

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from a ratings perspective.

Headquartered in White Plains, NY, FSC is an externally managed business development company, formed in 2007 with an objective to generate both current income and capital appreciation through debt and equity investments. As of Dec. 31, 2013, the company had investments in 111 portfolio companies amounting to approximately \$2.4 billion at fair value.

Fitch has affirmed the following ratings:

--Long-term Issuer Default Rating (IDR) at 'BBB-';

--Secured debt at 'BBB-';

--Unsecured debt at 'BBB-'.

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'

Applicable Criteria and Related Research:

-- 'Global Financial Institutions Criteria' (January 2014);

-- 'Investment Manager and Alternative Funds Criteria' (December 2013).

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Global Financial Institutions Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=732397](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=732397)

Investment Manager and Alternative Funds Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=725057](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=725057)

Additional Disclosure

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