“Expanding Equity Investment in Small Business”

Testimony before the Sub-Committee on Oversight and Investigations
Committee on Small Business
United States House of Representatives

March 26, 2009

Patrick Dalton
President & Chief Operating Officer
Apollo Investment Corporation

Chairman Altmire, Ranking Member Fallin, and members of the Sub-Committee

My name is Patrick Dalton. I am President and Chief Operating Officer of Apollo Investment Corporation, an SEC regulated Business Development Company (commonly known as a "BDC"). We are publicly traded on the NASDAQ stock exchange. For the five years since our IPO in April 2004, Apollo Investment Corporation has invested over $5.5 billion in 124 small and middle-market businesses across the United States, with current access to additional available capital of approximately $700 million.

As successful as our company and our industry have been, I am here today to let Congress know that the mission this body gave the BDCs 29 years ago— to provide much needed capital to small and mid-size companies—is in danger unless prudent policy steps are taken now. I am not here to ask you for money. Far from it. I am here to ask for some commonsense policy help so that we can use the money we have to originate loans and support the very companies this committee cares so strongly about.

But first, the good news.

We estimate the nation's BDCs currently have a combined loan and investment portfolio of over $30 billion that provides capital to over 1,400 small and middle-market businesses, with an average loan of $14 million. These loans are the lifeblood of Main Street businesses that support over 1.2 million U.S. jobs. In 2007, we estimate that BDCs provided approximately 50% of all junior debt capital loans (known as subordinated or mezzanine loans) to the small and mid-sized businesses throughout the United States.

I want to offer you two investment examples so you can see the type of work we are doing. In September 2004, Apollo Investment Corporation partnered with another BDC to provide a $45 million mezzanine loan to support the acquisition of Anthony, Inc. a San Fernando, CA manufacturer of glass refrigerator and freezer doors with over 550 employees. In 2005, we provided $45 million in mezzanine loans to LVI Services, Inc., a New York City-based company that employs over 2,000 workers. LVI provides integrated remediation, demolition, restoration and emergency response services to a broad range of clients throughout the U.S. The examples are typical of the type of loans that we, and indeed the BDC industry at large, provide to small and mid-sized businesses. The common themes running through these investments are:

1. an inability of small and mid-sized companies to secure financing from mainstream commercial banks;
2. a close working relationship between us and company management throughput the life of the investment; and
3. a hold-to-maturity philosophy where our exit is defined by the company's repayment of loan

As many of you know, Congress created BDCs in 1980 under amendments to the Investment Company Act of 1940 in direct response to the crisis in the capital markets that threatened small businesses during the late 1970's. Today, we are in what many believe is a “once in a century recession”. Small and middle-market businesses have been abandoned once again by the traditional sources of capital. BDCs remain among the very few investment vehicles, along with the SBICs, that are continuously dedicated to lending to smaller businesses. Our industry is lending in excess of $30 billion. None of us wants to see capital of this magnitude withdrawn from, or otherwise unavailable to, the small and middle-market.

It is our strong belief that BDCs occupy a unique regulatory space. Like banks and other commercial lenders which are not subject to the 1940 Act, we originate, structure, and make loans directly to companies with the intention of holding most of these loans to maturity. However, unlike those institutions, the 1940 Act imposes several important differences. We are a much less levered investment vehicle than banks, with a ratio of debt to equity of a mere 1:1. Further, we are required by statute to invest at least 70% of our capital in small and middle-market U.S. businesses. And while we all make similar discrete hold-to-maturity loans, BDCs are obligated to mark-to-market 100% of our loans, while the banks and other commercial lenders only mark-to-market a minority of their assets.

BDCs are regulated under the 1940 Act and therefore fall under the supervision of the Investment Management Division of the SEC, whose primary function is regulating mutual funds. Mutual funds -- unlike BDCs -- must invest and trade primarily in liquid assets and are required to stand ready to redeem shareholders at Net Asset Value at any time. Yet, as described above, unlike mutual funds, BDCs are originators of illiquid loans to small and mid-sized companies that take many months to complete and which we intend to hold-to-maturity.

Because we are regulated under the 1940 Act, we have always used fair value principles to value our portfolio. Prior to the implementation of FAS 157 and its interpretive guidance, the industry used fair value measurements based on the underlying credit fundamentals - that is, the collectability of interest and principal and the pricing of new mezzanine loans.

The record of "Back Testing" of our values demonstrates the high accuracy of this methodology. When our fair values are compared to our exit values achieved when the loans were repaid, one finds that our valuations over many years were within a very tight range.

Unfortunately, we have been forced by changes in accounting rules and auditor practice to "fix" what wasn't broken. With the implementation of FAS 157, the accounting community now requires that our illiquid assets be valued as if they were trading assets being sold into a hypothetical market too often drawn from a series of distressed asset sales of other illiquid assets that are not at all comparable to our individualized, performing loans. We believe that this practice has caused artificial asset value write downs for the BDCs, without meaningful regard to the credit quality of the underlying assets.

Ironically, investors—who are supposed to be protected by accounting rules-- are no longer able to discern the difference between the credit worthiness of a BDC's assets and general market dislocations that have nothing to do with the performance of our loans.

And most important to the mission of this Committee, this same accounting asymmetry results in many fewer loans -- and perhaps the cessation of all origination activities -- to the small business community by the BDCs. Every BDC, under the current interpretations of FAS 157, finds itself hoarding cash rather than making loans so they will not trip their statutory one-to-one asset coverage test that I mentioned earlier.

Mr. James Kroeker, the Acting Chief Accountant of the SEC in his testimony on Mark-to-Market Accounting before the House Financial Services Committee stated, "When mark-to-market accounting is not applied, unrealized investment losses are only recognized if the value of the investment is impaired. For debt securities that will be held to maturity, such impairment is generally only recognized if it is probable the investor will fail to recoup the invesment's contractual cash flows - that is, when credit loss has occurred."[1] Let me state for the record, that the BDC industry applauds Mr. Kroeker's statement, and agrees 100%. However, these insights have been denied to BDCs since the implementation of FAS 157.

[1] Testimony of James Kroeker, Acting Chief Accountant, U.S. Securities and Commission, House Subcommittee Hearing on Capital Markets, Insurance, and Government Sponsored Enterprises, "Mark-to-Market Accounting: Practices and Implications," (March 12, 2009).

Apollo Investment Corporation, I am pleased to state, has recently reported that we are in compliance with all of our covenants. Yet, we still must be cautious about using any of our $700 million of available capital toward originating new loans. We have, therefore, voluntarily chosen to curtail new lending activities until such time as there is a resolution to this issue**. This means that while we have the ability and desire to lend, we are unable to do so because of the policy and interpretive guidance that has emerged post-FAS 157.**

Unfortunately, some of the other established BDCs have already violated their Asset Coverage test, largely I believe, due more to volatility in the general markets rather than overall weakness in their own portfolios. The result has been an industry-wide downward spiral in stock prices with little or no regard to fundamental performance, thereby preventing us all from raising new capital. This situation has impacted the overall industry and hurt the BDCs' public equity investors and the small business community.

Our industry has had several meetings and discussion with the Investment Management Division of the SEC. We have also met with the Acting Chief Accountant of the SEC, as well as with each of the Commissioners of the SEC. We would like to thank each of them for the time and effort they put into understanding our issue. We also applaud the new Chairman of the SEC for meeting with our industry so soon after she was sworn in as

Chairman to learn about our industry and the very serious challenges that we face in fulfilling our mandate.

And as many of you know, the leadership of this Committee has written the SEC asking that regulatory reforms that might mitigate this problem be taken quickly before further deterioration occurs.

But as of today, we are still in need of your help. We have made three suggestions to the Commission and it is to those three suggestions that I want to return.

1. First and Foremost, we ask that BDCs be expressly included in the work that FASB and the SEC has been tasked with by the House Financial Service Committee to respond with improvements to Mark-to-Market Accounting. If we were able to offer true fair value accounting to our "hold to maturity" loans, we could—and would -- resume lending.

2. If we are denied relief from current accounting procedures under FAS 157, we ask that BDCs be given temporary authority to raise preferred stock, and treat those shares as equity rather than debt for the asset coverage test purposes. While this will not solve the problem, it may help some BDCs ride out the storm, and there is past precedent to justify it.

3. Also consistent with prior actions for other industries, we are asking for a temporary relaxation of the asset coverage limits. Again, while this will not solve the underlying problem, it will assist select BDCs, and in conjunction with the preferred stock proposal outlined above, assist some additional BDCs, in returning to more active lending in the market place.

In closing, let me end where I began.

I am not here to ask for taxpayer money. I am not asking for a bailout of an industry that made bad decisions or was too highly leveraged. I am here solely to ask for your help in returning us to the public purposes for which you—the Congress-- created BDCs 29 years ago.

It would indeed be a shame if common sense did not prevail. Thank you.