Business Development Companies Methodology

Credit Rating Agency

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Oscar Herrera, CFA
oscar.herrera@hrratings.com
Financial Institutions / ABS Manager


Roberto Soto
roberto.soto@hrratings.com
Financial Institutions / ABS Sr. Executive Director


Angel García
angel.garcia@hrratings.com
Financial Institutions / ABS Sr. Executive Director


Felix Boni
felix.boni@hrratings.com
Chief Credit / Economic Analysis Officer


Ricardo Gallegos
ricardo.gallegos@hrratings.com
Deputy Chief Economic Analysis Officer

The present methodology establishes the process by which HR Ratings evaluates credit worthiness of Business Development Companies (BDCs), which are institutions unique to the United States financial system. As such, they are subject to specific regulatory requirements established in the Investment Company Act of 1940. This methodology considers the characteristics of these institutions, both from a regulatory and operational perspective, to capture their ability to fully and timely comply with their payment obligations.

The rating process is mainly based on a quantitative analysis grounded on an understanding of the BDC's position in terms of its income generation capacity, its ability to constitute and maintain a portfolio with low volatility, and the management of its funding sources. The composition and trends of the relevant accounts for the analysis of these concepts are used to generate a financial model whose main results are expressed using the categories of; i) Asset Quality, ii) Profitability & Efficiency, iii) Capitalization & Leverage, iv) Liquidity. The standard rating process considers two years of historical information and the projection for the next two years of a series of financial metrics in a Base Scenario and in a Stress Scenario. However, modified timeframes of analysis are available for recently established institutions that cannot yet comply with this requirement or when historical information is not representative of the expected performance of the Entity. The result of this quantitative analysis can be modified by the addition or subtraction of qualitative notches following the concepts established in this methodology to establish a credit rating.

The assumptions that HR Ratings will use to construct its scenarios will depend on the characteristics observed for each BDC as well as the overall macroeconomic environment assumed for each scenario. The projected Base Scenario considers the evolution that, in the opinion of HR Ratings, has a higher probability of occurrence while the Stress Scenario seeks to emulate a scenario of adversity for the entity being rated considering the main risks to which its exposed.

HR Ratings may assign qualitative adjustments to the rating, in either direction, for factors that cannot be fully incorporated into the model, for example: (i) adjustments for the portfolio's composition, (ii) liquidity position, and (iii) regulatory & legal risks, (iv) franchise strength, (v) management & strategy, (vi) unstable sources of income.

Introduction

Business Development Companies are institutions specific to the U.S. financial markets, regulated under the Investment Company Act of 1940. These institutions focus on funding small and middle-market companies and have several requirements with which they must comply to keep their registry as a BDC. For instance, they must maintain at least 70% of their investments in eligible assets[1] and must balance their use of leverage to comply with an asset coverage ratio (ACR)[2] of 200% or 150% depending on the limit under which the BDC chooses to be regulated.

Many BDCs are associated with larger investment institutions as they serve as a vehicle to provide funding to middle market businesses, an activity in which larger banks tend not to participate due to regulatory constraints. As the spaces of private equity and private credit have grown over the last decade BDCs find themselves increasingly competing amongst themselves and other market participants in the business of direct lending to mostly sponsored-backed middle market companies.

BDCs can be either internally or externally managed. The operations for externally managed BDCs including loan origination, underwriting and portfolio management are carried out by an external adviser which is typically paid a management fee plus incentive-based payments based on portfolio performance. Internally managed BDCs employ their own staff to perform all necessary functions.

The main business activity for BDC involves extending funding instruments to small & middle market companies. Most BDCs choose to be registered as a Registered Investment Company for corporate tax purposes. Once a BDC chooses to be supervised as an RIC they must distribute at least 90% of the ordinary taxable income to shareholders, including short-term capital gains. Therefore, BDCs are highly reliant on access to capital markets and other sources of funding like institutional loans since they cannot retain generated capital. A well-diversified pool of funding sources and the proper management of liquidity risks are key determinants of a stronger BDC.

To understand BDCs' creditworthiness, it is necessary to establish the quality of its investment portfolio and its ability to maintain consistent and resilient earnings. BDCs investment portfolios are composed with instruments that can be classified as riskier than the average portfolio position of other investment institutions. These instruments are more volatile, generally illiquid and typically do not have available market prices. BDCs are required to provide quarterly valuation on their investment positions for which little data may be available. Thus, the valuation processes applied by the valuation designee, a function that can be carried out internally or assigned to an external provider, play a major role in giving timely guidance on the BDCs position, management's ability to generate a sustainable strategy which allows them to reach their investment goals and to mitigate the impact of adverse conditions.

HR Ratings methodology considers the characteristics of the operation of a BDC and establishes an analytical process consisting of three steps: first, an analysis of the BDC's assets & liabilities which are the basis of the credit quality position of an institution. Once the position and operation of the BDC is established, the second step is to develop a financial model which considers a set of financial metrics both from historical data and from HR Ratings' own forecasts in a base and a stress scenario.

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[1] An eligible portfolio company for a Business Development Company (BDC) is a U.S.-based operating company that is either unlisted or listed on a national exchange but has an aggregate market capitalization of less than $250 million.
[2] (Total assets – (Total Liabilities - (Total Debt - Small Business Administration (SBA) Borrowings))) / (Total debt - SBA Borrowings)

The final step refers to the assignment of qualitative adjustments, to capture factors that cannot be completely incorporated into the financial model and that may have an impact on the entity's credit quality.

Figure 1. Structure of the Methodology

Quantitative Analysis

Analysis of the BDC's Assets	Analysis of the BDC's Funding Sources
-Investment portfolio composition -Historical trends -Risk position	-Availability of Funding -Cost associated to funding -Funding management

Financial Ratios

Asset quality ratios	%
Net realized gains/avg portfolio at fair value	15%
Net unrealized appreciation (depreciation)/avg. portfolio at fair value	4%
Non-accruals/avg portfolio at fair value	6%

Profitability & Efficiency	%
Net investment income / avg portfolio at cost	7%
Net increase in assets resulting from operations	5%
Efficiency index	3%

Capitalization & leverage	%
ACR cushion	20%
Debt/Equity	10%

Liquidity & Funding ratios	%
Unsecured debt/total debt	20%
Liquid assets / payment obligations	10%

Qualitative Analysis

Adjustments for a portfolio's composition	Franchise strength
Liquidity position	Management & strategy
Regulatory & legal risk	Unstable sources of income

Source:HR Ratings

2. Quantitative analysis of the BDC

For its quantitative analysis, HR Ratings develops a financial model that is based on historical financial statements. The information required by HR Ratings includes quarterly reports on the Income Statement, Balance Sheet and Cash Flow Statement, preferably for the last 5 years (completed or partial) since this timeframe can provide a better understanding of the BDC's recent position and a clearer basis for the financial forecasts. In case the BDC has a shorter operation history, the process will consider the financial statements available.

For most cases, the rating process will consider two years, or eight quarters, of both historical and forecasted data. In cases where HR Ratings evaluates a recently formed BDC that does not have sufficient historical information, it may consider only one year of historical information and the corresponding two years of projections.

The following three sections describe HR Ratings' analysis of BDC's assets, liabilities and both its interest rate and currency risk. The fourth section describes the metrics, grouped according to the concepts of profitability & efficiency, solvency and liquidity. The fifth section describes the assumptions that are typically incorporated into the projection scenarios; while the last section shows an example of how the financial model generates a credit rating.

2.1 Analysis of the BDC's Assets

BDC's main function is extending financing and investing in small and midsize corporations with an important restriction of investing at least 70% of the total value of its assets in eligible portfolio companies. Consequently, one of the main considerations for its credit risk analysis is the asset quality that the BDC can maintain through its business focus, underwriting practices and risk management.

There are multiple important factors related to the composition of a BDC's loan portfolio that impacts the overall asset quality of the institution. Starting with the asset class composition, a focus, for example, on first-lien senior secured instruments provides greater security than a portfolio with higher representation of unsecured or lower lien instruments. Some BDCs could have an important percentage of their portfolio invested in equity in middle market companies. This strategy could render them especially vulnerable to external shocks with impact over the business operations of these companies both in terms of their valuation and their ability to pay dividends.

Having a grasp on the BDC's risk tolerance and protocols regarding specific macroeconomic or industry conditions is a key determinant for forecasting the stability of the portfolio both in the base and the stress scenario.

The analysis considers all other factors that could provide the BDC with greater protection against losses from default alongside asset class composition, for example, strong underwriting practices with a high composition of financial covenants and the BDC being the direct lender or the lead investor in a co-investment transaction which would favor its position in negotiations.

Another factor considered in this analysis is the strategy of the BDC in terms of its industry diversification. Management can decide whether the best business strategy available to them is a position diversified through different productive sectors or if a focus on a specific niche will provide better opportunities. This decision can be of particular importance during periods of market turmoil or macroeconomic challenges. The spread of systemic risk through the portfolio could be worsened if the underlying companies are exposed to similar vulnerabilities at the same time. This situation could have serious implications for the BDC as it would affect its overall portfolio valuation, its earnings if companies start to fail on their payments and even their immediate liquidity position if there is off-balance sheet pressure from the undrawn commitments for which they are responsible.

Since a BDC's portfolio has an inherently higher credit risk due to its focus on small and middle size companies, the historical and expected generation of portfolio non-accrual's will be a key determinant of a BDC's asset quality analysis. This factor is considered important enough to have a direct impact on the credit rating through the financial model. The BDC's ability to manage unfavorable trends in non-accrual generation as shown in their historical information and formalized strategies will inform the projections for evolution of the portfolio in both the base and stress scenarios.

Lastly, the analysis will use any other source of relevant information like a review of the due-diligence and underwriting processes carried out by the BDC, the integration of the investment committee, the robustness and transparency of portfolio valuation processes carried out internally or by a third party, and exposure to market risk through the mixture of fixed and floating rate instruments.

2.2 Analysis of the BDC's funding sources

BDC's regulatory constraints make them heavily reliant on access to capital markets for funding their operations. As such an important part of the analysis focuses on the diversity and robustness of funding sources these institutions can maintain. An appropriate management of a mix of credit facilities with different financial institutions, funding through equity and use of debt instruments, initial public offerings (IPOs) and capital calls to their investors are crucial for funding the capital-intensive portfolio of a BDC.

Since a BDC's portfolio is mostly illiquid, proper management of short-term maturities is crucial to ensure a stable liquidity position. As such, the levels of unrestricted cash, restricted cash for the purpose of investment, short-term amortizations of their debt investments and funding available through credit lines or other undrawn commitments are the main components the BDC must properly maintain to avoid any non-payments on its obligations.

Some debt instruments may be securitized by a priority security interest in a portion of the investment portfolio or cash. Any nonpayment of these instruments could severely compromise the liquidity position of the institution as the claims on its assets may hinder management's ability to fulfill other obligations.

A BDC's ability to raise additional capital is usually tied to the proper management of their ACR as they are not allowed to issue preferred shares or acquire additional debt if its ACR levels would breach 150% or 200% limit they chose to be regulated under. A breach of the minimum requirement would compromise the institution's registry as a BDC. To avoid the consequences of losing its status a BDC could be forced to sell some of its investments at a discounted price to pay a portion of their debt until the appropriate levels of ACR are attained.

Proper management of funding is also crucial for carrying out an effective investment strategy as the institution may be limited in their ability to capitalize on investment opportunities, either strategic investments or full acquisitions, if they find themselves restricted at inopportune times.

2.3 Financial ratios

This section details the ratios constructed using both the historical and forecasted financial results of a BDC. These indicators capture different aspects of a BDC's financial position starting with its ability to generate and maintain high quality assets. Afterwards, the financial ratios describe the entity's profitability & efficiency. The third set of ratios refers to the BDC's capitalization and leverage position, while the fourth looks at its exposure to funding & liquidity risks.

Asset quality ratios

Net realized gains / Average portfolio at fair value

(15.0% of Financial Model)

Realized gains are measured as the difference between the net proceeds from the repayment or sale of an instrument and the amortized cost basis of the investment at the time of exit. This ratio serves as an indicator of the quality of underwriting for the BDC. Constant cumulative realized losses could signal weak underwriting practices. The levels of gains/losses of a BDC serve to measure the institutional ability to maintain a stable portfolio which is an important factor in sustaining appropriate asset quality levels. While a BDC's main source of revenue is usually the income attained from their interest or dividend payments, the ability to exit their positions with a favorable outcome generates additional gains that help for the payment of their obligations including their dividend payment.

$$\frac{Net\ realized\ gains(losses)\ LTM}{LTM\ Avg.portfolio\ at\ fair\ value}$$

Figure 2 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 2. Net realized gains to average portfolio at fair value rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥5.50%)	(5.50%,4.70%]	(4.70%,1.95%]	(1.95%,-2.70%]	(-2.70%,-7.00%]	(-7.00%,-9.45%]	(x≤-9.45%)

Source: HR Ratings.

Non-accruals / Portfolio at fair value

(6.0% of Financial Model)

Loans are placed on non-accrual status when principal or interest payments are past due or there is reasonable doubt that they could be collected in full. A loan could be reclassified to accrual status when payments are restored, and it is determined that the remaining payments will be paid on a timely basis. On some occasions, management teams may choose not to place loans on non-accrual status if they are deemed to have enough collateral and are already in the process of collecting.

The ratio reflects the quality of the assets that the BDC originates, which in turn reflects the due diligence process and other controls the BDC employs when granting funding to its portfolio institutions. The analysis of non-accrual generation must be segregated between the different concentrations that can be tracked within the portfolio. The ability to differentiate between different risk profiles for every sector identified in the portfolio allows the BDC to prepare and implement mitigation strategies to respond to negative trends. The expected evolution of non-accrual considered in both the base and stress scenario will consider the macroeconomic impact over the portfolio and the strategies that management has in place to counteract any unexpected negative volatility.

$$\frac{Non-accruals\ in\ the\ last\ quarter}{Portfolio\ at\ fair\ value\ in\ the\ last\ quarter}$$

Figure 3 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 3. Non-accruals to portfolio at fair value rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≤0.15%)	[0.15%,0.50%)	[0.50%,1.45%]	[1.45%,3.00%)	[3.00%,4.25%)	[4.25%,4.90%)	(x≥4.90%]

Source: HR Ratings.

Net unrealized appreciation (depreciation) / Avg. portfolio at fair value
(4.0% of Financial Model)

Unrealized Appreciation (Depreciation) is used to track the changes in market or fair value of the instruments in a portfolio. Net unrealized gains/losses serve as an early indicator of possible negative trends affecting the portfolio as they are made in relation to the adjustment of the market or fair value of investments in each valuation period. For this ratio the quality of the quarterly valuation process of the BDC will be a key determinant for the forecasted value considered in the rating process. Whether the BDC uses in-house valuations or valuations done by a third-party, the processes must be transparent in their decision making and the basis used for the final values registered. Some BDCs could be further exposed if they hold investments involving different currencies as any gains or losses from currency translation will be recorded under this account.

$$\frac{Net\ unrealized\ appreciation\ (depreciation)\ LTM}{LTM\ Avg.portfolio\ at\ fair\ value}$$

Figure 4 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 4. Net unrealized appreciation(depreciation) to average portfolio at fair value rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥9.50%]	(9.50%,9.10%]	(9.10%,7.5%]	(7.5%,5.00%]	(5.00%,2.80%]	(2.80%,1.50%]	(x≤1.50%)

Source: HR Ratings.

Profitability & Efficiency

Net investment income / Avg portfolio at cost
(7.0% of Financial Model)

Investment Income from a BDC can be generated from different sources. While most of their income will be generated from interests paid by portfolio companies, some BDCs may heavily lean on dividends or paid in kind (PIK) payments as part of their strategy. These institutions report on the sources of income segregated into three main categories: 1) non-controlled/Non-affiliated investments, 2) non-controlled/affiliated investments, 3) controlled/affiliated investments where the categorization depends on the amount of voting securities held by the BDC. The ratio integrated in the financial model will consider net investment income, however, the trends and expectations of the income generation attributable to each of these categories will be a key input used for the forecasted evolution of the BDCs earnings.

This ratio represents the main measure of the earnings capacity of the BDC. For investment income it is important to check the historical stability of cashflows or if there is a recent increase in the risk profile of the portfolio which in turn increases the income generated. Low or negative income could signal a problem with the business strategy or underwriting practices of the BDC. In any case, an understanding of the composition of the portfolio and management's expectation of future results in investment income will inform the forecasts for this indicator.

$$\frac{Net\ investment\ income\ LTM}{LTM\ Avg.portfolio\ at\ cost}$$

Figure 5 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 5. Net investment income to average portfolio at cost rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥11.00%]	(11.00%,9.25%]	(9.25%,7.50%]	(7.50%,5.70%]	(5.70%,4.00%]	(4.00%,2.20%]	(x≤2.20%)

Source: HR Ratings.

Net increase in assets resulting from operations / Total assets
(5.0% of Financial Model)

Net increase(decrease) in assets resulting from operations captures the performance of the BDC's business operations for the recorded period. This measure plays a key role in many indicators commonly tracked by investors like earnings per share. A constant positive result signals that the investment activities for the BDC are enough to maintain a profitable operation that can generate earnings and increases in Net Asset Value (NAV) without the need for capital contributions. Additionally, the period's result directly determines the available resources for distributable income, and they are the starting points for capital planning in terms of future stock purchases.

$$\frac{Net\ increase\ in\ assets\ resulting\ from\ operations\ LTM}{LTM\ Avg.Total\ assets}$$

Figure 6 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 6. Net increase in assets resulting from operations to total assets rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥,8.00%]	(8.00%,7.40%]	(7.40%,5.65%]	(5.65%,2.65%]	(2.65%,0.00%]	(0.00%,-1.65%]	(x≤-1.65%)

Source: HR Ratings.

Efficiency index

(3.0% of Financial Model)

Internally and externally managed BDCs differ in terms of their operating expenses based on the payment structure used for both types of staff. Externally managed BDCs compensation schemes are established through an investment advisory agreement where a base management fee and an incentive base fee are set. For internally managed BDCs compensation is set through staff salaries and on some occasions stock-based compensation programs.

This indicator measures the BDC's efficiency by contrasting non-debt and non-tax operating expenses with the total investment income generated in the period. In other words, the costs generated by the BDC's business operations are evaluated in proportion to the income received because of their strategies. The indicator is constructed as follows:

$$Efficiency\ index = \frac{(Total\ operating\ expenses - \ interest\ and\ other\ debt\ expenses - tax\ expenses)\ LTM}{Total\ investment\ income\ in\ the\ LTM}$$

Figure 7 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 7. Efficiency index rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≤8.00%)	[8.00%,14.70%)	[14.70%,32.50%)	[32.50%,61.50%)	[61.50%,85.65%)	[85.65%,98.00%)	(x≥98.00%]

Source: HR Ratings

Capitalization and Leverage

Asset coverage ratio (ACR) cushion

(20.0% of Financial Model)

BDCs are required to maintain an asset coverage ratio of 200% as their regulatory limit or can choose to be regulated under a 150% ACR threshold. This requirement presents a strict limit on the ability of the BDC to fund its operations using debt financing. Any breach of the applicable threshold will usually carry significant consequences for the institutions both from a regulatory perspective and as a common indicator included in the covenants of debt instruments used by the BDC. If an insufficient cushion is maintained between the institution's ACR and the minimum requirement, the portfolio might be subject to an immediate significant change that could involve the sale or disposal of investment at inopportune times. This sudden deviation from the initial investment strategy could lead to further issues with earning generation, a mismatch between funding availability and payment obligations, and hinder the BDC's ability to make distributions.

$$ACR = \frac{(Total\ assets - (Total\ liabilities\ - (Total\ debt - SBA\ borrowings)))\ in\ the\ last\ quarter}{Total\ debt - SBA\ borrowings\ in\ the\ last\ quarter}$$

$$ACR\ Cushion = ACR - Regulatory\ ACR\ level$$

Figure 8 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 8. ACR cushion rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥55.00%]	(55.00%,52.15%]	(52.15%,42.5%]	(42.50%,26.00%]	(26.00%,10.50%]	(10.50%,2.00%]	(x≤2.00%)

Source: HR Ratings.

Debt/Equity

(10.0% of Financial Model)

This ratio expresses the relationship between capital and the use of debt as founding sources. This indicator has a direct relationship with the level of ACR the BDC must maintain. An ACR of 200% essentially limits the ratio to a maximum of 1.0x and the 150% threshold for the ACR restricts debt/tangible equity to a maximum level of 2.0x. The relationship between these accounts gives us information about the capital structure of the BDC, their reliance on debt for funding their operations and in turn the sustainability of their investment plans at their current levels of leverage.

$$\frac{Total\ debt\ in\ the\ last\ quarter}{Equity\ in\ the\ last\ quarter}$$

Figure 9 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 9. Debt to equity rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≤0.30)	[0.30,0.45)	[0.45,0.75)	[0.75,1.30)	[1.30,1.70)	[1.70,1.90)	(x≥1.90]

Source: HR Ratings.

Funding & Liquidity

Unsecured Debt / Total Debt
(20.0% of Financial Model)

The capital structure of a BDC in terms of the relationship between their use of unsecured and secured debt instruments is commonly seen as a measure of financial flexibility. The ratio can be interpreted as the institutions having fewer assets pledged as collateral and therefore available for any use they might deem necessary in the future. While this measure is not a precise proxy for unencumbered assets as any secured debt could be overcollateralized and the measure lacks any insight into the quality of the pledged assets against those that remain unencumbered it still gives information about the capital planning instrumented by the institution.

$$\frac{Unsecured\ Debt\ in\ the\ last\ quarter}{Total\ Debt\ in\ the\ last\ quarter}$$

Figure 10 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 10. Unsecured debt to total debt rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥95.00%]	(95.00%,93.50%]	(93.50%,80.00%]	(80.00%,44.50%]	(44.50%,13.00%]	(13.00%,3.00%]	(x≤3.00%)

Source: HR Ratings.

Liquid assets/ payment obligations
(10.0% of Financial Model)

This ratio is a measure of exposure to liquidity risk from off-balance sheet liabilities, amortization planning on their debt maturities and regular interest payments on BDCs funding sources. Unfunded commitments are composed of either lines of credit or delayed draw commitments available to portfolio companies and for which the BDC stands as funding provider. The indicator captures the coverage that a BCD holds for a stressed situation in which it would have to provide funding for all unfunded commitments standing at the period of analysis. Additionally, it considers the interest expense on an LTM basis and any debt maturities that fall within the analyzed period. While this indicator gives guidance on the liquidity position of a BDC there could be situations where it does not fully encompass the levels of risk an institution faces when the forecast shows an inability to meet its necessary payments. This situation rises from the restricted nature of the impact a single indicator can have on the financial model based on the standardized application of ratio weights and period weights. Whenever it is deemed necessary, additional qualitative adjustments can be made to impact on the credit quality of a BDC based on their liquidity position.

$$Liquid\ assets\ to\ payment\ obligations = \frac{(Cash + Credit\ lines\ Available\ from\ Funding\ Sources)\ \ in\ the\ last\ quarter}{\begin{array}{c}(Interest\ Expense\ in\ the\ following\ 12\ months + Debt\ Maturities\ in\ the\ following\ 12\ months \\ +Unfunded\ Commitments\ in\ the\ last\ quarter\ )\end{array}}$$

Figure 11 shows the values used to categorize the results of an entity's indicator within the different rating ranges:

Figure 11. Liquid assets to payment obligations rating ranges

HR AAA	HR AA	HR A	HR BBB	HR BB	HR B	HR C
(x≥4.00]	(4.00,3.80]	(3.80,3.00]	(3.00,1.90]	(1.90,0.75]	(0.75,0.15]	(x≤0.15)

Source: HR Ratings.

Projection Scenarios

HR Ratings' analysis is based on the projection of the BDC's financial performance in two scenarios: the Base Scenario and the Stress Scenario. Both scenarios consider the current macroeconomic, regional, and industry specific trends that could have an impact directly on the forecasted evolution of the BDC. Both scenarios will consider the particulars of the BDC's portfolio in terms of different kinds of concentration, historical losses, composition and the adherence to the set of risk limits set by management. Whenever any relevant additional information is available through public disclosure channels or privately obtained from the management the impact will be considered for both scenarios. For example, changes in strategy in terms of investment objectives an composition, the acquisition of another entity, important changes to the capital structure in the coming years, plans to be executed to avoid funding mismatches or any other that represents a change from the implied evolution the BDC would have if the current trends and structure were to be taken as guidance for the forecasts.

Base Scenario

The forecasts included in the base scenario consider the entity's most likely evolution based on the analysis of its historical performance, expected business and operational evolution as reported by the entity, and HR Ratings' own macroeconomic projections. The ability to constantly achieve its investment objectives and the effective management of business operations will directly impact on the expectations for the BDC's evolution both for externally and internally managed BDCs. As previously mentioned, BDC's must adhere to regulatory constraints relating to several key items such as leverage usage, sources of income, asset composition and dividend distribution. The limits applicable to each BDC and their plans to keep the appropriate levels will be integrated into the projection scenarios.

The most important consideration in terms of the forecast scenario is the composition of the investment portfolio since it represents the basis for the BDC's earnings power, asset quality and credit risk. In terms of earnings power, the focus will be on the BDC's generation of consistent and resilient earnings. The analysis will look favorably at portfolios generating income through predictable sources such as instruments paying recurring interest income as opposed to portfolios which depend on less reliable sources of income generation such as dividends or gains from sale of investments. The historical volatility of income generation will be the main consideration for the forecast of the portfolio's behavior in the base scenario. If the BDC's business plans involves the sale of investment instruments in the near-term, the realized gains from such sales could be integrated into the projections using the current fair value of the instruments at the time of analysis. Otherwise, the analysis will assume that no sales of instruments are realized during the time periods included in the rating forecast. In a similar fashion, income generated from dividends may be penalized in projected scenarios as it represents a less predictable source of income.

BDCs' portfolios naturally hold a higher risk profile from their exposure to small and middle market companies. However, the regulatory constraints they adhere to naturally limit their risk-taking. Furthermore, their risk monitoring and mitigation processes play an important part in maintaining an appropriate level of asset quality throughout their investment portfolio. When available, a review of their due-diligence processes, underwriting and origination practices, investment guidelines and committees, valuation processes (internal or third-party), risk monitoring tools and procedures could inform the expectation for the evolution of the instruments in non-accrual. Otherwise, the forecasted evolution of the portfolio will be influenced by the concentration in terms of industry, the position of the investment instruments in the capital structure of the portfolio's companies, main client concentration, unrealized appreciation (depreciation) volatility and the historical trends affecting such positions.

The exposure of the portfolio to market risk will consider the position in terms of floating vs fixed rate instruments. The evolution of the relevant macroeconomic factors like real GDP, inflation and interest rates will follow the economic forecasts internally prepared by HR Ratings.

Stress Scenario

HR Ratings stress scenario considers the evolution integrated in the base scenario and incorporates the impact of key risk factors to analyze the resilience of the BDC when facing a combination of challenges to their results. The main source of risk, and therefore, the main factor considered when stressing the BDC comes from their investment portfolio position.

To stress the investment portfolio HR Ratings will consider the historical results of non-accruals. When available, the data on non-accruals generated for different concentrations in industries, instrument types, clients and risk profiles will be studied to understand the behavior the portfolio has shown during different economic conditions. This will be the basis for setting the parameters the BDC will face in the stress scenario. Additionally, macroeconomic factors, risk tolerance limits, criteria for originating and underwriting loans, historical management of non-accrual will all impact the expectation for the growth of non-accruals. Losses in terms of the portfolios' market value will be derived from the analysis of the counterparty credit risk, exposure to market volatility, protections available to the BDC, proportion of secured and unsecured positions.

HR Ratings develops its own internal economic forecast scenarios with different macroeconomic impacts to important factors, for example, a scenario where the local economy goes through a period of stagnation. The vulnerability of each BDC will be analyzed to choose the scenario whose conditions represent the most congruent challenge to the BDC's evolution.

Whenever the analysis of the BDC exposes a source of vulnerability other than the ones described in this section the analysis report will expose the additional factors considered in the analysis and their impact on the results included in the financial model.

Construction of the financial model

The first step is to forecast the evolution of the BDC in both scenarios through its financial statements, which will be used to construct the financial ratios. In this step, it is important to clarify that each indicator is calculated for the last two years of historical information and for the following two projected years. The process may rely on quarterly or annual reports as a basis depending on the availability of audited financial information. Each period and each ratio receive a specific weight as established in the previous sections.

Figure 12 below shows the weight and quarters that correspond to each year evaluated. The figure also considers cases in which the BDC does not have at least two years of historical information. In these cases, only one historical year, and the two years of projections for each scenario will be weighed.

Figure 12: Intertemporal weightings

Year	Quarters and Years Considered (with *at least two years* of historical information)	Weight
t_{-1}	The penultimate year of available historical information.	30.0%
t_0	The last year of available historical information.	40.0%
t_1	The first year of projections.	20.0%
t_2	The second year of projections.	10.0%
Year	**Quarters and Years Considered (with *only one year* of historical information)**	**Weight**
t_0	The last year of available historical information.	60.0%
t_1	The first year of projections.	25.0%
t_2	The second year of projections.	15.0%

Source: HR Ratings.

The second step in the Financial Model rating process consists of assigning an integer value between 1 (lower credit quality) and 19 (higher credit quality) to the year-weighted average of each metric. The ranges necessary for each ratio to be mapped to a specific rating level are revealed in the figures previously shown for each indicator. The following figure shows the possible integer values that a metric can take given its rating range.

Figure 13: Value-to-range

Rating Range	Integer Values
HR AAA	{19}
HR AA	{16,17,18}
HR A	{13,14,15}
HR BBB	{10,11,12}
HR BB	{7,8,9}
HR B	{4,5,6}
HR C	{1,2,3}

Source: HR Ratings.

The third step is to make a weighted average of these integer values to assign a rating to each scenario, according to the weights set out in the section in which the metrics were described. Finally, both scenarios will be averaged, where the Base Scenario receives a weight of 65% and the Stress Scenario the remaining weight of 35%. Figure 14 provides an example of how the value of both scenarios and the result for the financial model is calculated, showing the weights and value in the curves corresponding to years and metrics.

Figure 14: Example of the financial model

Base Scenario	*Intertemporal Weights*	**30.0%**	**40.0%**	**20.0%**	**10.0%**	**Intertemporal W. Avg.**	**Rating Value**	**Weight for ratios**
	Years	t_{-1}	t_0	t_1	t_2			
Asset quality								
Net realised gains/ Avg. portfolio, at value		-0.82%	1.36%	0.27%	0.32%	0.38%	11	**15.0%**
Non-accruals/ Portfolio at value		2.96%	1.88%	2.42%	2.90%	2.41%	11	**6.0%**
Net Unrealized Appreciation (Depreciation)/ Portfolio, at value		4.30%	6.16%	5.23%	6.28%	5.43%	10	**4.0%**
Profitability & Efficiency								
Net Investment Income/ Avg portfolio, at cos		4.79%	6.64%	5.72%	6.86%	5.92%	10	**7.0%**
Net Increase in Assets Resulting from operations/ Total assets		4.36%	5.36%	4.86%	5.83%	5.01%	12	**5.0%**
Efficiency Index		29.01%	24.45%	26.73%	32.07%	27.04%	13	**3.0%**
Capitalization & Leverage								
Asset coverage ratio cushion		30.00%	39.90%	34.95%	41.94%	36.14%	11	**20.0%**
Debt/equity		124.09%	110.51%	117.30%	140.76%	118.97%	10	**10.0%**
Funding and liquidity								
Unsecured debt/total debt		0.69	0.76	72.30%	86.76%	74.10%	12	**20.0%**
liquid assets/payment obligations		0.89	1.13	1.01	1.22	1.05	7	**10.0%**

Stress Scenario	*Intertemporal Weights*	**30.0%**	**40.0%**	**20.0%**	**10.0%**	**Intertemporal W. Avg.**	**Rating Value**	**Weight for ratios**
	Years	t_{-1}	t_0	t_1	t_2			
Asset quality								
Net realised gains/ Avg. portfolio, at value		-0.82%	1.36%	0.16%	0.19%	0.35%	11	**15.0%**
Non-accruals/ Portfolio at value		2.96%	1.88%	2.90%	2.87%	2.51%	10	**6.0%**
Net Unrealized Appreciation (Depreciation)/ Portfolio, at value		4.30%	6.16%	3.14%	3.77%	4.76%	9	**4.0%**
Earnings & profitability								
Net Investment Income/ Avg portfolio, at cos		4.79%	6.64%	3.43%	4.12%	5.19%	9	**7.0%**
Net Increase in Assets Resulting from operations/ Total assets		4.36%	5.36%	2.92%	3.50%	4.38%	11	**5.0%**
Efficiency Index		29.01%	24.45%	32.07%	33.91%	28.29%	13	**3.0%**
Capitalization & Leverage								
Asset coverage ratio cushion		30.00%	39.90%	20.97%	25.16%	31.67%	10	**20.0%**
Debt/equity		124.09%	110.51%	140.76%	150.76%	124.66%	10	**10.0%**
Funding and liquidity								
Unsecured debt/total debt		68.76%	75.84%	43.38%	52.06%	64.84%	11	**20.0%**
liquid assets/payment obligations		0.89	1.13	0.61	0.73	91.55%	7	**10.0%**

Rating by Scenario	**W.Avg. Base**	**W.Avg. Stress**	**Base scenario weight**	**65.0%**	**Final V.**
	10.70	10.08	**Stress scenario weight**	**35.0%**	**10.48**

Source: HR Ratings.

This figure shows an example in which the metrics are averaged for each year. All relevant weightings: weight by years, metric, and scenario are indicated in green. HR Ratings builds the metrics for each year and obtains a weighted average that is displayed in the "Intertemporal W Avg." column. The value obtained in this column for each metric has an equivalent integer value between 1 (lowest) and 19 (highest). These are shown in the "Rating Value " column.

The next step is based on estimating the weighted average of the metrics considering the weights shown in the "Weight by Metric" column. In this example, the integer values of the Base Scenario average 10.70, while in the Stress Scenario 10.08. Considering the weight of 65% and 35% respectively, of these scenarios, the Financial Model results in a value of 10.48 equivalent to an HR BBB-.

4. Additional considerations

HR Ratings analysis may implement a series of additional considerations for factors with credit quality implications that cannot be fully integrated in the financial model. This section presents the most common causes of qualitive adjustments implemented during the analysis of a BDC. Any additional adjustments, whether negative or positive, used in the credit rating of a BDC will be identified and justified in the rating report.

4.1. Adjustments for a portfolio's composition

While an important part of the analysis process integrates the asset quality of the portfolio as direct measure used in the financial model there could be some situations where the inherent risk of a position has not been fully captured through the numbers reported in the financial statements. This could happen due to the weight of the financial model given to the historical position of the institution, not allowing the analysis to integrate the extent of the change reflected in the forecasted position. Another reason for applying adjustments could be high volatility in the ratios used to follow the asset quality of the portfolio such non-accruals, realized & unrealized gains and income generation. If historical information cannot provide a clear view of the trends affecting the portfolio, then a qualitative adjustment may be used to correct the uncertainty this situation generates in forecast periods. Other factors that can be attached to a qualitative adjustment for a portfolio's composition include a highly concentrated position in riskier asset types such as equity positions, concentration of any kind that is deemed to represent a risk beyond the effect captured in the rating model, a portfolio composition that endangers the BDC to lose its regulatory compliance with the applicable 70% of eligible assets limit or may force them to do a quick restructure to ensure they stay in line with their requirements.

4.2. Liquidity position

The funding & liquidity section applied to the financial model deals with the position of the BDC as it faces its overall funding and liquidity challenges over the term being analyzed. However, this analysis may fail to fully integrate the risks faced by the BDC if they were to fail in maintaining an appropriate funding scheme to facilitate timely payment of important debt maturities. If this were to be the case the BDC may face accelerated maturity from other financial obligations that would compromise their ability to maintain business operations. Where HR Ratings identifies an important future liquidity event that could compromise the BDC, it may use additional qualitative adjustments to capture said risk even if its impact is beyond the rating time horizon considered for the financial model.

4.3. Regulatory & legal risks

Any prior breach of regulatory requirements could result in consequences not yet reflected in the financial statements of the institution at the time of analysis. Whenever a BDC is going through the process of a resolution for breaches in regulation or is part of a legal proceeding additional qualitative adjustments may be used to negatively impact the credit rating of the entity as the forecasts being used in the financial model will not be able to integrate the resolution of said proceedings until they are determined by the appropriate authorities. If there is a history of regular regulatory noncompliance or the institution being a target of constant legal proceedings, negative qualitative adjustments may be applied to integrate the compliance risk of the institution even if it is not involved in any legal or regulatory process at the time of analysis.

4.4. Franchise strength

A BDC's historical position in the market could have an impact in terms of their access to both investment opportunities and funding sources. An assessment of the franchise strength could be supported by some quantitative factors, for example, sustained growth balanced by adequate asset quality vs fast growth attained by taking riskier positions. As mentioned in other sections, BDCs tend to be part of a larger investment institution and in some cases, this might confer certain advantages over independent BDCs. Like access to more experience team of investment advisors, a robust funding platform, best practices in terms of origination and underwriting, amongst others. The tenure of the BDC could be another important factor and their market participation.

4.5. Management & strategy

The ability of the BDC's management team to implement effective strategies for achieving their investment objectives while maintaining an investment portfolio with volatility constraint to the expected levels can imply stability for the institution beyond what would be seen in the indicators used in the financial model. When available, information about internal manuals and processes alongside historical information of implemented strategies during times of turmoil can be considered in the development of the BDC's forecasts and if deemed appropriate a qualitative adjustment can be used to reflect the strength of these concepts.

4.6. Unstable sources of income

BDCs can generate investment income from three main sources, interest income, dividend income and PIK interests. While based on their usual business operations most BDCs will rely on interest income as their main source of revenue. Whenever either dividend income or PIK interest represents an important proportion of revenues an additional negative adjustment could be applied if deemed necessary.

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Media Contact

comunicaciones@hrratings.com