

Research Studies and Opinions

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BDCs and Saratoga in 2016

A Q&A

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Question: What's the difference between a BDC and a bank?

Answer: The 60+ BDCs now in existence do not have the regulatory burden and constraints of banks and can, therefore, operate more freely. Since Dodd-Frank, banks have been moving away from making loans to the lower end of the middle market because of the regulatory costs and capital changes. Conversely, BDCs can make cash-flow loans to lower middle-market companies because BDCs evaluate the companies as going concerns. Banks generally see these companies as sources for asset-based lending with rigorous repayment covenants and rigid collateral requirements that limit overall funding levels.

Question: How have BDCs affected middle-market borrowing and growth?

Answer: BDCs are becoming the alternative go-to sources of capital for lower middle-market companies, especially those searching for expansion, mergers and recapitalizations.

Question: What is the largest obstacle facing BDCs today?

Answer: From an operating standpoint, it is maintaining credit discipline. While it is easy to take on risk when the economy is running well, risk can turn on a lender quickly in a downturn. For example, BDCs with too many investments in the energy market were hit hard with losses once the price of oil plummeted. At Saratoga, we avoided the energy market and kept a diversified portfolio, thus avoiding related credit losses.

Question: BDCs are a relatively new factor in corporate finance; how well are they known among middle-market businesses?

Answer: BDCs are still not that well known among lower middle-market companies, but that is changing rapidly. Because of their increasing popularity as an alternative to loan-resistant or loan-constrained banks, BDCs are gaining market share.

Question: Saratoga Investment has had a successful five-year run, even though when you bought the predecessor company to Saratoga, things looked pretty dismal. What did you do to turn the company around?

Answer: We recapitalized the company, brought in a new management team and instilled strict discipline into our lending practices. We largely worked out the legacy portfolio and redeployed the capital into stronger credits.

Question: What is the total return for Saratoga's stock and what is its dividend yield?

Answer: Our total return has been in excess of 18 percent over 1-, 3-, and 5-year intervals, with a dividend yield in excess of 9%. This compares quite favorably with other BDCs and ranks Saratoga in the top decile of total returns.

Question: What is your dividend rate?

Answer: The dividend increased throughout 2015 and the most recent in 2016 is 40 cents per share. There was also a special dividend of \$1 a share during the second fiscal quarter of the current fiscal year.

Question: Are you still selling at a discount to NAV?

Answer: Yes, we and the entire industry, with a few exceptions, are priced at a discount to NAV. We believe that this makes Saratoga stock an exceptional opportunity for value as well as yield.

Question: Is Saratoga similar to a REIT? If so, in what way?

Answer: A BDC functions like a REIT in that it passes through most of its income in the form of dividends. It is also not taxed at the corporate level, but rather at the shareholder level, resulting in only one level of taxation.

Question: How big is Saratoga's portfolio of middle market companies?

Answer: Presently, we have about 35 companies in our investment

portfolio, and we add one or two companies a month. We now have \$550 million under management.

Question: What is happening in the middle market that BDCs can take advantage of?

Answer: There is good growth in the lower end of the middle market and therefore, significant opportunities for investment.

Question: What is your growth strategy going forward?

Answer: We will continue to build our origination efforts and expand our pipeline of opportunities while maintaining the credit discipline, which has rewarded shareholders thus far.

Question: Has the sluggish growth of the economy affected middle-market lending? If so, how?

Answer: There has been a slowdown in mergers and acquisition activity in the middle market which has led to fewer investments relative to the supply of capital. We are now seeing early signs of a change in this dynamic.

Question: If rates rise as a result of the Fed's recent rate increase, how will that affect middle-market lending and what impact will this have on BDCs?

Answer: A growing economy will increase demand for credit from BDCs. While refinancings might slow a bit, the need for capital for growth and acquisition should continue. Most BDCs have a majority of their loans structured as floating rate, and so, aside from some friction from LIBOR floors, their portfolios are generally well structured for rising rates.

Question: In your view, what are the future prospects for BDCs and, in particular, Saratoga Investment?

Answer: The prospects for BDCs are bright, particularly given the structural change in bank appetite for the markets we serve. We see plenty of opportunity at Saratoga Investment for solid growth consistent with our record over the past five years.

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