

# Research Studies and Opinions

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## Choosing BDCs as an investment

### A Q&A

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**Question: How many BDCs are there in which to invest?**

**Answer:** There are nearly 60 companies that have elected to be regulated as a business development company (BDC) under the Investment Company Act of 1940. They represent \$65 billion in assets under management and \$25 billion in market cap.

**Question: You recommend against choosing a BDC's stock based solely on yield. Why?**

**Answer:** It's an inaccurate metric. Yield doesn't tell you anything about the underlying business. Yield should be based on return on equity as opposed to the percentage of yield of the stock. ROE includes both net investment income, as well as the gains and losses of the investment and thus the success of the investment strategy. Dividend is another metric that can be inaccurate. Some BDCs pay out dividends that are higher than their earnings. At some point, they have to cut dividends to reflect the underlying deterioration of the business, and then investors get burned as stock prices drop.

**Question: So what metrics should one use when considering whether to invest in a BDC?**

**Answer:** There are several and all pertain to the health of the business. A company's record of building Net Asset Value (NAV) with high quality assets is important to consider. Saratoga's NAV, for example, is up 76% since 2010, which is a CAGR of 8%. Assets under management are up 202% since 2010, a CAGR of 21%, and more than 98% of our loan investments have the highest credit rating. This indicates that management is concerned

with the health of the BDC and is not pushing heedlessly for growth. And then ROE and total return are also very important.

**Question: How should one consider return on equity and total return?**

**Answer:** Best way is to compare these to the industry. For example, Saratoga has an ROE of 9.4 LTM versus 0.9% for the overall BDC industry and 10.8% average over the past five years as compared to 7.2% for the industry. Saratoga's total return over the last 12 months was 12% versus -2 % for the BDC index. The total return trend is similar for the three- and five-year period as well. Sustained ROE growth and total return are a sign of a healthy BDC.

**Question: What about capacity for growth?**

**Answer:** Consider whether the BDC has the capital to expand in the future. For example, Saratoga has the ability to grow assets by 35% without new external financing with an available fund investment capacity of \$98M as of our last year-end. A BDC must maintain sufficient headroom for lending, and many struggle with that currently because they are trading below NAV and cannot raise equity, yet have no remaining capacity.

**Question: How should an investor consider dividends and stock price to NAV?**

**Answer:** Look at dividend growth and coverage. Saratoga has grown its dividend by 52% in just over a year, and by 128% since end of 2014, and is over-earning our dividend by 17% on average over the past year -- one of the highest in the industry. As for stock price to NAV, look for a stock price trading at a discount to NAV. Saratoga's stock is trading at a 25 % discount to NAV at the moment, so has ample room to appreciate.

**Question: What about the management team?**

**Answer:** One of the most important factors, this is where everything starts. Check to see whether the management team has experience and is invested in the BDC. Saratoga, for example, has a combined 90+ years of experience investing in middle-market businesses and has a proven performance record since taking over the BDC in 2010. Moreover, management and insiders own approximately 37% of shares. When experienced management has a stake in the business, it pays closer attention to the ongoing and long-term health of the enterprise rather than boosting performance for the short run.

**Question: What about portfolio quality and exposure?**

**Answer:** Look for careful and disciplined capital deployment. Unfortu-

nately, a number of BDCs recently suffered significant portfolio value adjustments because they had taken on credits that have gone sour. They grew too quickly. Many BDCs went heavily into energy lending during the oil and gas boom and have had to take significant write-downs with the energy downturn. The key here is to invest in credits with strong characteristics, rather than following growth trends.

**Question: What should an investor look for in the types of companies that a BDC invests in?**

**Answer:** That is going to vary by BDC and its particular focus. Saratoga invests in later-stage, small- and middle-market companies (\$10 million to \$150 million in revenue, \$2+ million in EBITDA) with strong margins and free cash flow. We look for an exceptional management team with a meaningful stake in the business, a leading market position or niche with sustainable competitive advantages, recurring or repeatable revenue with loyal customers and attractive margins and modest capital expenditures and working capital requirements. We look at hundreds of deals but fund only tens. In 2015, we sourced 613 deals, provided term sheets to 67 and closed on 16, an average of four deals a quarter. This comes from our strong commitment to disciplined investing. Other successful BDCs will have different characteristics and strategies, but will maintain discipline.

**Question: What kind of industry profile should an investor expect?**

**Answer:** This too will vary by BDC. Saratoga looks for established, well-defined industries with solid growth characteristics in healthy end markets. These include business services, light manufacturing, franchise businesses, consumer and healthcare services industries. We want high barriers to entry. We do not want high R&D, early-stage technology, or pure commodity industries. And we look for the industry's ability to withstand business cycles. Other BDCs will focus on different marketplaces, such as technology. We also look to diversify on the basis of geography, so if one region of the country goes into recession, it will not harm the overall portfolio. Texas and the Dakotas are in recession with the plummeting price of oil. A BDC portfolio heavily weighted in those geographies is facing write-downs. The type and location of industry is not as important as disciplined investing and diversification.

**Question: What else should be considered?**

**Answer:** These metrics discussed above should be enough to give an investor a clear picture of a BDC and its place among its peers. Considering yield alone is a siren song. It's simple, attractive and wrong. Look at the fundamentals of the BDC first and develop a fuller picture of the underlying company. When you do that, you can invest with greater comfort, especially with BDCs whose stock is thinly traded. Remember that a BDC

is a variable-income distribution mechanism, with at least 90% flow-through of earnings in the form of dividends. It functions more as a bond than a stock. Pick a BDC with operating results that will provide a competitive interest rate over the long term, and there will be less need for trading in and out of the stock.

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