SARATOGA INVESTMENT CORP.

Research Studies and Opinions

Banks Are Not Lending to Middle-Market Companies

A Q&A

Christian L. Oberbeck
Chairman of the Board and CEO
Saratoga Investment Corp.

Question: Why are big banks leaving the middle-market?

Big banks, and small banks, are leaving the smaller middle-market, and in particular, companies below $10 million in EBITDA. That's a hard cutoff for a lot of banks. They can do asset-based loans for those companies that can be collateralized. But they don't like to do cash-flow loans against sub-$10 million EBITDA companies because these companies are story credits, meaning an unsecured lender has to trust that cash flow will be enough to repay the loan. When the bank examiner comes in and says, "How are you going to get home on this one?" as soon as you start telling the story, their eyes glaze over. They don't want to hear it. Whereas if you're lending money to a company with $100 million in EBITDA they'll say, "What happens if you have a problem here? Can the company access the 'public' markets? Can they issue bonds?" There are more avenues of flexibility for larger companies. Scrutiny from the controller of the currency and other bank regulators is creating an environment where the path of least resistance for banks is to abandon story credits or those perceived to have higher risks.

Question: Do you see that ending?

Not for a long while, especially with new regulations coming down.

Question: Was this the situation 10 years ago?

No.

Question: Has it happened as a result of the crash and from Dodd-Frank?

Yes. What's happened is that regulatory authorities have reawakened to the risk of banks as depositor-funded institutions with an explicit government guarantee to their depositors. Regulators want to make sure that bankers aren't taking depositors' money and lending it in risky ways. So, Basel III, Dodd-Frank… there are all kinds of rules to make sure banks are capitalized adequately and have capital charges relative to the type of loans that they make. If you make a loan to a small company that a BDC would service, your capital charge inside the bank might be high. For example, if you make a loan to GE your capital charge might be a small percentage of your exposed position to GE. However, if you're making a loan to a company with $5 million of EBITDA, the capital charge might be 10 or 20 times as high. That uses up equity. Banks are better off lending to more conventionally creditworthy entities because of the way they are regulated.

Question: So smaller companies have been edged out of banks, and BDCs have stepped into the breach?

Yes.

Question: Are there alternatives to a BDC if you're a $5 million EBITDA company?

You could go to a private equity fund, but that's not exactly the right answer. You could go to a mezzanine fund, which would give you a certain slice of your debt needs. You could go to a senior debt fund that might give you another. The advantage that BDCs can provide is a total solution with a one-stop shop.

Question: What should a CEO expect when financing with a BDC?

CEOs should expect a very knowledgeable credit partner who understands how businesses work generally and understands their businesses in particular, and understands the ebbs and flows, and cycles and the like. CEOs should expect a BDC to be a business partner -- not necessarily an equity partner, but a debt partner in the growth of their business. As a BDC, we consider ourselves lucky when we have decades-long relationships with our companies. Once you underwrite a company, once you understand its credit and get to know that company, you'd like to stay with it for as long as it needs capital.

With a BDC you get continuity that comes from longevity because it is a permanent capital vehicle. For example, if a company is financed by a mezzanine fund with a finite life, and years down the road you want to do a recapitalization, that fund might not be there because the fund is going to end in three years; so it can't re-up for a new seven-year deal. Whereas a BDC has permanence, so it can continue to stay with your company and grow with you. What a CEO can expect from a BDC in financing is a very knowledgeable capital structure partner that could be a very long relationship.

Question: This sounds like what we used to call relationship banking, minus the bank.

It is relationship financing.

# # #